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ARTICLES

INTRODUCTION TO THE SYMPOSIUM

WARREN F. SCHWARTZ*

The terrible events of September 11, 2001 confronted our society with the necessity to fashion an appropriate legal response. Three perspectives competed for dominance in the process through which the legal response was devised and implemented: (1) It was possible to look backward and seek guidance from what had been done in comparable situations. (2) The events of September 11 could be viewed as essentially sui generis, requiring decisive, prompt and unprecedented action by public and private institutions. (3) The events of September 11 could be viewed as providing the necessity, but also the opportunity, to determine the principles which would control the public and private responses to terrorist attacks which might occur in the future.

It seems fair to say that the second perspective was dominant, particularly in the days immediately following September 11. Nothing like this had happened before. The focus should be on the uniqueness of the task facing the legal system. But, it is also true, that as public and private agencies struggled to provide the answers to the host of questions, which had to be confronted in deciding exactly what they were to do, that the past and the future emerged as more important determinants of the societal response. Implicit and explicit judgments had to be made about the appropriateness of employing existing institutions to accomplish various objectives or to create new institutions designed to deal with the particular issues implicated by the terrorist attack. A principled approach had to be formulated in order to answer the central question of how much compensation should be paid to different individuals and firms harmed directly or indirectly by the attack. The tort system had long struggled with the problem of devising a coherent theory of compensation, particularly with respect to non-pecuniary harm. The answers provided by tort doctrine remain extremely controversial. Would it be better (1) to utilize the existing tort system, whatever its imperfections, (2) create a new agency which would derive the substantive principles it would apply through (among other things) a selective incorporation of torts jurisprudence or (3) create a new institution which would supply its own substantive principles, unconstrained to any degree by what had been done in the tort system, or any other system providing compensation for

* Professor of Law and Director, the John M. Olin Program in Law and Economics, the Georgetown University Law Center. The Papers in the symposium were presented at a Conference on "The Law and Economics of Providing Compensation for Harm Caused by Terrorism" sponsored by the Olin Program.

various types of harm? In sum then, an evaluation of the historical performance of the tort system and other institutions providing compensation was an essential element in fashioning an appropriate response to the terrorist attack.

The future also had to be considered. This was so for two reasons: (1) Events like those occurring on September 11 might occur again. Terrorism represented a continuing threat. Did it matter whether the principles employed to determine appropriate compensation for harm caused by the September 11 attack could be generalized to govern the compensation provided for harm resulting from future attacks? 2) Decisions with respect to compensation, if they were made applicable to future attacks, or would be viewed as precedent for the legal response to future attacks, would also shape the incentives of actors to take costly steps to reduce the likelihood or severity of harm resulting from future events.

Virtually all of the important decisions with respect to determining the roles of various public and private institutions and the principles which would govern their actions, were implicit. There was little discussion of alternatives which might have been employed. The contributions to this symposium may be fruitfully viewed as making explicit the social choices which underlay the actions which were taken. They capture both what was genuinely "new" and "distinct" about the issues implicated by the events of September 11 and the extent to which these issues were examples of basic questions with which the legal system has struggled for a very long time.

Marshall Shapo's analysis of the September 11th Victim Compensation Fund of 2001, created by Congress less than two weeks after the attack, elegantly locates the fund in what he calls our "jurisprudence of injury." He shows that intense political pressures led Congress essentially to reject the customary means employed, most significantly, the tort system, to provide compensation for injury. The result was an unprecedented procedural system conferring enormous power on a Special Master, appointed specifically to administer the fund, and a no-fault substantive regime unlike any which had been seen before.

The creation of the fund, then, represented an extreme example of what I have characterized as the sui generis approach. Powerful social forces combined to induce Congress to respond as it did. These forces include: (1) There was an outpouring of compassion by the general public. Providing generous compensation to the victims was seen as an expression of solidarity and an affirmation of the ideals of the American Society. Ironically, perhaps, the act of giving took on a great importance of its own. Much less thought was given to the question of what should determine the amount which a particular victim received. (2) The intentional tortfeasors who had committed the terrorist acts could not be the source of the required compensation. There was great concern about subjecting public and private institutions (principally the airlines), who could be charged with negligence for failing to take adequate precautions to prevent the terrorist attack, to the costliness and uncertain outcomes of the tort system. (3) Existing tort doctrine was thought to be unable to answer the question of what constituted appropriate compensation in these unprecedented circumstances. Perhaps, most significantly, victims were viewed, in varying degrees, as heroes whose survivors should be rewarded for their valor. (4) The airlines presented

a particularly difficult question. On the one hand they might appropriately be required to compensate victims because of their negligence in preventing the attacks. On the other they had experienced serious losses, for which they were not responsible, because of the attacks.

The Shapo essay does a remarkable job of sorting out these complexities and explaining how Congress dealt with them. The story he tells should be particularly fascinating to scholars interested in public choice or torts.

Robert Katz's essay provides a detailed and perceptive account of the large, wholly unprecedented, role played by charitable organizations in distributing to victims the vast sum contributed by the truly astounding total of two-thirds of American households. In one essential respect the problem facing the charities was like that faced by the Victims Compensation Fund. Donors' contributions were an expression of grief, solidarity and patriotism. Their motivation was the felt need to respond to a national tragedy. They did not focus on the complex question of how the funds they were providing should be shared among victims. They were, however, clear that they wanted the money to go to victims. As a result, the charities found themselves under intense pressure to distribute the funds they had received but little guidance as to how to distribute them.

The historical practices of charities in responding to disasters and the legal rules defining what a charity must do to qualify for favorable tax treatment combined to provide a very uncomfortable answer to this question: Charities are not the appropriate institutions to provide compensation to individuals for harm resulting from calamitous events. Charities provide short term disaster relief like medical supplies, food and shelter, and funds for emergency expenditures. Their long term compensatory role is limited to needs based monetary assistance and in kind relief of the poor. As a result, returning to the opening portions of this introduction, the justification for the response of the charities could not be found in what had been done before. Distributing more than a billion dollars to victims, some of whom were very wealthy, was different than providing soup kitchens to feed the destitute or blankets to people driven from their homes by a flood. The focus of the donors was exclusively on the horror of the September 11 attack. Instructed by their donors to fashion a sui generis response, not surprisingly, the charities' behavior was, ad hoc, inconsistent and uncoordinated.

The most interesting question posed in the Katz essay is whether this ad hoc response will provide beginnings for a new, more extensive, conception of what the role of charities, in responding to national tragedies, *should* be.

Hillel Sommer's essay provides an illuminating comparative perspective on the American response to the terrorist attack. He traces the evolution of the very different Israeli approach to the problem of providing compensation for harm caused by terrorism. As it is now constituted, Israeli law grants a wide range of monetary transfers and in kind assistance to victims of terrorist attacks. The legal provisions with respect to harm caused by terrorism are part of the very extensive social welfare regime in place in Israel. Benefits for victims of terrorism are larger than those available to people whose needy condition results from other causes and approximately the same as those furnished to soldiers killed in the ongoing cycle of terrorism and counter terrorism.

The Sommer essay also expresses the reaction of a person familiar with the

Israeli system to what has been done in the United States. The striking aspect of the American system to an Israeli observer is its ad hoc nature. The compensation regimes established for the various terrorist incidents are entirely different. Professor Sommer's reaction implicates fundamental questions concerning compensation for harm caused by terrorism: What are the principled reasons for treating victims of various terrorist attacks differently? Even more generally, what are the principled reasons for treating persons harmed by terrorism differently than persons harmed in other ways?

Margaret Blair's essay shifts the focus of the symposium from the harm to individual victims to the large economic losses experienced by the airlines. The legislation authorizing economic assistance to the airlines was passed very quickly, to a significant degree as part of the outpouring of solidarity and patriotism which underlay the public and private provision of compensation to individuals. The economic assistance took several forms: (1) immunity from tort claims by victims who chose to receive compensation from the Victims' Compensation Fund; (2) a limitation in the liability of victims who choose to forgo payment from the fund and, instead, sue in tort, to the "limits of the liability coverage maintained by the air carrier"; (3) cash payments as compensation for the large losses directly caused by the terrorist attacks; and (4) a subsidy for payment of the high price of liability insurance in the period following the terrorist attack.

The Blair essay focuses on the most extensive and controversial form of assistance authorized by the legislation. The financial situation of several of the airlines was so bad that bankruptcy loomed as a real possibility. Their situation had certainly been materially worsened by the terrorist attacks. But basic economic circumstances, which defined the competitive environment of the industry, also lay at the heart of the difficulties experienced by firms in the industry.

Congress was faced with the difficult and controversial task of fashioning a "bail out" policy for the industry. Of course, this policy could have consisted of providing no financial assistance. However, Congress responded by enacting legislation authorizing large, long term financial aid, in the form of loan guarantees. At the same time, the decision as to how much aid would actually be provided to individual airlines was delegated to an agency created for this purpose. As is often the case in situations of this kind, the vague criteria which were enunciated to control the decisions of this agency indicated that Congress was eager to appear generous. At the same time, however, the "hot potato" of deciding what actually was to be done was thrown to another institution.

At bottom, the implementing agency faced a task which could not coherently be accomplished. It was asked to provide loan guarantees only in those situations in which it was anticipated that the loans would be paid so that the guarantees would not have to be honored. In the words of the Blair essay, the agency was to "pick winners" who would succeed and be able to pay their debts. Achieving coherence was further complicated by two additional factors: First, likely "winners" could obtain financing in the capital market and did not require government assistance and second, the government, like any other supplier of capital, could capture some of the upside potential of likely winners by acquiring

an equity interest in the firm.

As the Blair essay explains, the drama of the implementing agency deciding which firms to help, and on what terms, is not over. So far relatively little assistance has been provided. But the plot is still thickening as the firms in the industry jockey for competitive advantage, and the government officials carefully study the political tea leaves.

The three remaining essays in the symposium focus on the third source of funds for compensating individuals and firms for the harmed caused by the terrorist attack: private and public insurance. Insurance varies from the other two sources, charitable giving and government payments, in a fundamental respect. The relevant decisions with respect to the first two of these sources are primarily made after the fact. Harm has occurred and the question is what to do about it. In the case of insurance, however, the relevant decisions are made before the fact. Individuals and firms decide how much compensation they wish to purchase for harm which might occur in the future. These decisions are disciplined, in the case of private insurance, by the need to pay premiums in sufficient amounts for insurance companies profitably to provide the agreed upon compensation if one of the covered harmful events occur. Government insurance could, in principle, also be provided subject to the profitability constraint. Political pressures, however, often lead to subsidization in the form of premiums which are insufficient to provide the compensation required when a harmful event occurs. Two specific issues relevant to determining the role which privately and publicly supplied insurance should play in determining the compensation which is provided for harm caused by catastrophic events like the September 11 terrorist attack are considered in two of the essays. The third essay comprehensively addresses the general question.

Jeffrey Thomas' essay examines the efforts of the insurance industry to adapt to the uncertainty of future terrorist attacks engendered by the huge, largely unanticipated, liability which the industry faced as a result of the September 11 attack. The industry sought relief from Congress in the form of the federal government bearing a portion of the risk of future harm. The outcome of this effort remains in doubt. The focus of the Thomas essay is on the companion effort to seek state regulatory approval for an exclusion of coverage for losses resulting from terrorist activity. The industry sought the exclusion in part because most insurance carriers, unconstrained by government regulation, had refused, in the renewal of contracts in January 2002, to provide coverage for terrorist caused losses. It was claimed that a $25 million loss would threaten the solvency of many companies writing commercial property/casualty insurance. State regulators responded by approving an exclusion from terrorist caused harm if the liability of an individual firm exceeded this amount.

The Thomas essay analyzes the complexities involved in framing and implementing such an exclusion. Some of these complexities are similar to issues arising under the Israeli law providing compensation. Essentially, they arise from the necessity of defining exactly what constitutes a "terrorist" event. The second difficulty is, however, unique to the exclusionary clause which was adopted. The difficulty arises because if the threshold $25 million in losses is exceeded, a company need pay nothing. The threshold thus creates a

discontinuity. If the liability of a company is below the threshold, the company would like losses to be as low as possible, and its insureds, as a group, would like them to be as high as possible. As the threshold is approached, however, the company would prefer that losses be higher in order to gain the benefits of the exclusion. By contrast, its insureds would prefer that it be lower so that they are not deprived of coverage by the exclusionary clause. The Thomas essay contains interesting speculation as to how insurers and insured will behave in these circumstances. The question is a general one applicable to any regulatory solution in which insurers gain beneficial treatment if losses exceed a specified threshold.

The essay by Elizabeth and Terrence Chorvat adopts the innovative perspective of analyzing the federal tax system as a means for providing compensation for losses caused by terrorist activity. In one respect their analysis captures an insurance like function, implicit and unavoidable, in any income tax system. When economic losses are suffered income is reduced and compensation in the form of lower tax liability is provided. More controversially, they argue that special provision should be made in the tax law to reduce the income tax liability of victims of terrorism. Provisions of this kind were enacted for victims of the September 11 attack. The Chorvats argue that they should be made permanent features of the tax code.

This provocative proposal is made for two reasons. (1) If the government bears a portion of the losses resulting from terrorist acts, in the form of reduced revenue, it will provide an incentive for government decision makers to take adequate steps to reduce the likelihood and harmfulness of terrorist activity. (2) Individuals who take precautions which reduce the likelihood or severity of harm resulting from terrorist attacks create benefits for other potential victims. The creation of positive externalities justifies subsidization in the form of favorable tax treatment.

The details of the argument offered in support of these contentions offer interesting insights into the current tax treatment of expenditures designed to lessen or mitigate catastrophic losses. The essay also examines the incentive of government officials and private firms and individuals for taking costly precautions resulting from their anticipating the treatment of these losses after they occur. The essay also weighs in on the side of the before the event comprehensive approach as compared to the ex post ad hoc response.

The final essay in the symposium, by Anne Gron and Alan Sykes, offers a rigorous analysis of the question of whether the government should act as an insurer of losses resulting from terrorism because the private insurance market will fail to provide the required coverage. Although focusing on losses resulting from terrorism, the essay constitutes a major contribution to our understanding of the phenomenon of private insurance markets "failing." It, moreover, considers not only what failures will occur but whether, should they occur, the government can supply the insurance that the private sector will fail to provide.

The analysis is complex and subtle and I will not try to capture it in this brief introduction. In the most general terms, the essay analyzes two phenomena: (1) a short-term inadequacy of supply which may occur after catastrophic events like those occurring on September 11, 2001 and (2) A long term inability of the

private market to supply insurance coverage for events like those which occurred on September 11, 2001. The essay concludes that the private market has self-correcting forces which will lead to a reasonably prompt end to the shortage of coverage in the period immediately following September 11. The answer to the question as to whether a significant, persistent supply shortage may occur is complex and uncertain.

The essay concludes that while it is difficult to conclude with any great confidence what long term shortage of supply, if any, may occur, it is unlikely that the government can effectively diagnose and solve the problem by offering insurance supplementing what is available in the private market. (It appears that the Bush administration has reached a different conclusion in both of these respects.)

I conclude this introduction by reporting the strong sentiment of the contributors that these essays appear together in a single publication. I agree that the sum is greater than the total of the parts. I suggest that the reader will gain many interesting insights if she asks herself how the essay she is reading sheds light on the other contributions to the symposium.

COMPENSATION FOR VICTIMS OF TERROR: A SPECIALIZED JURISPRUDENCE OF INJURY

MARSHALL S. SHAPO*

I. A JURISPRUDENCE OF INJURY

The attacks of September 11 pose challenges to what I have called our jurisprudence of injury:[1] a comprehensive, if loosely defined system of law that includes tort, compensation statutes and regulation. The basic tort features of the events are clear. The primary wrongdoers were intentional tortfeasors, of whom the operational villains are dead and their managers, as a practical matter, are unreachable, unless the attacks eventually come to be tied to a government.

One could ascribe negligence to a number of secondary actors in the American private sector and also to the federal government. Although one may reasonably predict that any negligence of the government would be immunized by the discretionary function exception of the Federal Tort Claims Act,[2] this asserted negligence would provide a policy basis for the funding provided by the September 11th Victim Compensation Fund of 2001 ("Fund").[3] Further fleshing out the broad spectrum of the jurisprudence of injury, the Fund itself represents, in an extraordinarily complex way, the sort of compensation system that has been primarily associated with workers' compensation. Finally, various regulatory and quasi-regulation issues swirl around the subject after the fact, notably the question of how much the government should be involved in providing security against terrorists—in this case, airport security.

Complicating the analysis is what I have called, in another connection, the "Problem of the Missing Tsar."[4] Ideally, we might desire a sovereign who would make decisions on both an overall basis and a day-to-day basis about how the consequences of personal injuries are to be allocated among various social institutions. It is true that all of our traditions—philosophical as well as practical—militate against having a Tsar. What is striking about the legislation setting up the Fund, however, is that in fact we have created a sub-Tsar for the event: the Special Master.[5]

A global challenge to a targeted fund of this sort inheres in the

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* Frederic P. Vose Professor, Northwestern University School of Law. This paper was first published in 30 HOFSTRA L. REV. 1245 (2003). I gratefully acknowledge permission of the editors of the *Hofstra Law Review* to reprint the paper in this Conference issue. I also express my particular thanks to Professor Warren Schwartz for encouraging me to write this paper.

1. *See generally* MARSHALL S. SHAPO, ABA SPECIAL COMMITTEE ON THE TORT LIABILITY SYSTEM, TOWARDS A JURISPRUDENCE OF INJURY (1984).

2. 28 U.S.C. § 2680(a) (2000).

3. Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, §§ 401-09, 115 Stat. 230 (2001) [hereinafter Air Safety Act].

4. Marshall S. Shapo, *Tort Reform: The Problem of the Missing Tsar*, 19 HOFSTRA L. REV. 185 (1990).

5. Air Safety Act § 404(a).

compassionate desire to create a comprehensive umbrella for a wide range of misfortunes. At the other pole is the instinct to decentralize the allocation of injury costs as much as possible to those who cause injuries and to victims who have any responsibility for their injuries. Thus, our desire for large public policy solutions, of which the most comprehensive injury compensation plan on the planet is the New Zealand solution,[6] is forever at war with a tort approach, highly focused on the circumstances of particular injuries. The events of September 11 put these philosophical issues to a grisly test.

This essay focuses on the Victim Compensation Fund, which is one title of a broader statute, the Air Transportation Safety and System Stabilization Act.[7] I will comment on what Congress may have been thinking when it hurriedly passed this legislation, which is dated just eleven days after the horrific events in question. In addition, I will suggest some other rationalizations for this unique statute, including its specific combination of wealth transfers and liability limitations.

II. THE EVENTS

Let us briefly rehearse the facts of September 11 as they would appear in the narrow terms of the common law. The events in question arose out of a carefully planned set of intentional torts. Persons who were literally troglodytes, halfway around the world, conceived a massive series of trespasses and batteries with the purpose of inflicting emotional distress not only on victims but on the nation as a whole. As this is written, it is not beyond the realm of possibility that there may be some involvement of actual governments, in addition to unofficial organizations, in these events. If that were the case, there would be a potential to impose an international form of tort liability against those governments[8] as well as, theoretically, against individuals and nongovernmental groups.

From a domestic law point of view, however, the principal bases for tort liability lay in a set of possible negligences—or even strict liabilities—that might be taxed to various actors. These included private providers of security, whose alleged carelessness in hiring and carrying out their duties appeared to present a prima facie case of negligence. Those front-line negligent tortfeasors, however, were likely to be unsuable for anything like the amounts at stake.

More practical potential defendants were the airlines, who contracted with the security organizations, and who had independent responsibilities of care to their passengers and to others who would prove to be in harm's way. At least at the time the legislation was passed, before the disastrous plunges toward

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6. For a summary by a knowledgeable observer, see Sir Geoffrey Palmer, *Beyond Compensation: The New Zealand Experience*, 15 U. HAW. L. REV. 604 (1993).

7. Air Safety Act §§ 401-09.

8. *See, e.g.*, The Foreign Sovereign Immunities Act, 28 U.S.C. § 1605(a)(5) (1994 & Supp.) (allowing actions for damages "against a foreign state for personal injury or death, or damage to or loss of property, occurring in the United States and caused by the tortious act or omission of that foreign state" or its officials or employees).

bankruptcy of major carriers, the airlines were at least perceived to have had much more capacious pockets than the security firms. They were also the beneficiaries of the immunity provided by the waiver requirements the statute imposed on those who take advantage of the compensation system established for the victims of the attacks.

Another group of private parties that might be defendants were the makers of the airplanes, who could be alleged to have provided inadequate security for the flight deck. Finally, a possible defendant was the government, whose agents possessed fragments of information that, in retrospect, could be interpreted to create duties to prevent these deadly acts, with the variety of risks they presented to many interests.

I set against this background of legal theory a few personal anecdotes that have policy relevance to a day on which Americans will always remember where they were when they heard the news. As members of my law school community gathered in the school atrium during the first hours after the attacks, I encountered a woman whom I recognized as a member of the torts class that had just begun for the term. We chatted briefly about the possible effects of the events on civil liberties. The next morning I encountered her again, and she mentioned that she had been acquainted with a young man who had been a leader of the passengers' heroic stand against the hijackers on the Pennsylvania flight. That morning I also received an e-mail from another member of the class who told me that he would not be in class for some days because he had gone to New York City to see his orthodontist and could not get a return flight. He reported that his plane had landed at La Guardia at precisely 9:00 a.m. just as the attacks were in progress.

A fellow synagogue member of one of my sons, who lives in Northern Virginia, crawled from the wreckage of the Pentagon. A friend and former professional colleague of my other son, who lives in Illinois, was the recently appointed director of the New York Port Authority. He did not escape from his office in the eyrie of one of the Twin Towers. I record these stories purely as illustrations of the radiations of these events throughout the polity—examples of how in a dreadfully fortuitous way they tended, at least pro tem, to make that fragmented collection of a quarter billion people into a community.

III. THE LEGISLATIVE RESPONSE

Congress' provision of compensation to individuals focused on those who died or were physically injured by the attacks. The legislation setting up the Victim Compensation Fund[9] provides a virtual textbook of leading issues in contemporary injury law:

- It establishes a non-tort alternative for "any individual (or relatives of a deceased individual) who was physically injured or killed as a result" of the attacks.[10] This alternative is a specialized compensation system under the

9. Air Safety Act §§ 401-09.

10. *Id.* § 403.

administration of the Special Master.[11]

- "[T]he Special Master shall not consider negligence or any other theory of liability,"[12] and "may not include amounts for punitive damages in any compensation paid."[13]
- A remarkable subsection declares that "the amount of compensation to which the claimant is entitled" shall be "based on the harm to the claimant, the facts of the claim, and the individual circumstances of the claimant."[14]
- "The Special Master shall reduce the amount of compensation . . . by the amount of the collateral source compensation the claimant has received or is entitled to receive."[15]
- Collateral sources to be deducted from payments under the program include "life insurance, pension funds, death benefit programs, and payments by Federal, State, or local governments related to" the attacks.[16]
- The waiver of the right to file civil actions for those who submit claims under the Fund "does not apply to a civil action to recover collateral source obligations."[17]
- A claimant who submits a claim for compensation "waives the right to file a civil action . . . for damages sustained as a result of" the attacks.[18]
- For those who elect to sue carriers, there will be "a Federal cause of action" that "shall be the exclusive remedy for damages arising out of" the attacks,[19] and the liability of the carriers for both compensatory and punitive damages "shall not be in an amount greater than the limits of the liability coverage maintained by the air carrier."[20]

With a swiftness matched to the occasion, the Department of Justice, in consultation with the Special Master, who was appointed on November 26, 2001, moved to establish a detailed set of rules for the administration of the Fund. The rules, originally promulgated in the form of an Interim Final Rule on December 21, 2001,[21] include the following provisions as augmented in the Final Rule published on March 13, 2002:[22]

- "Eligible claimants" include those present at the attack sites "at the time of or in the immediate aftermath of the crashes . . . who suffered physical harm"

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11. *Id.* § 404.
12. *Id.* § 405(b)(2).
13. *Id.* § 405(b)(5).
14. *Id.* § 405(b)(1)(B)(ii).
15. *Id.* § 405(b)(6).
16. *Id.* §§ 405(b)(6), 402(4).
17. *Id.* § 405(c)(3)(B)(i).
18. *Id.*
19. *Id.* § 408(b)(1).
20. *Id.* § 408(a).
21. Interim Final Rule, September 11th Victim Compensation Fund of 2001, 66 Fed. Reg. 66,274 (Dec. 21, 2001) (to be codified at 28 C.F.R. pt. 104).
22. Final Rule, September 11th Victim Compensation Fund of 2001, 67 Fed. Reg. 11,233 (Mar. 13, 2002) (to be codified at 28 C.F.R. pt. 104).

and the personal representatives of those who died on any of the four hijacked planes or at any of the attack sites.[23]

- The Special Master "shall take into consideration . . . individual circumstances" that "may include the financial needs or financial resources of the claimant or the victim's dependents and beneficiaries."[24]
- Before the deduction of collateral sources, no compensation award could be less than $500,000 where a decedent had a spouse or dependent, or less than $300,000 if the decedent was single with no dependents.[25]
- In the case of decedents "who did not have any prior earned income, or who worked only part time outside the home," economic loss could be calculated "with reference to replacement services and similar measures."[26]
- "The presumed non-economic losses for decedents" would be "$250,000 plus an additional $100,000 for the spouse and each dependent of the deceased victim."[27]
- "[T]he United States shall be subrogated to all potential claims against third party tortfeasors of any victim receiving compensation from the Fund."[28]

IV. PROBLEMS IN ADMINISTRATION AND PUBLIC PERCEPTION

The statute and the rules, drafted under the pressure of public outrage at the events and compassion for the plight of the survivors, generated some difficult problems in practical administration as well as public relations. As the new year dawned, there were reports about the reluctance of potentially eligible people to sign on as beneficiaries of the Fund.[29] Television news clips captured the discomfiture of the Special Master, the very able and experienced Washington lawyer Kenneth Feinberg, as he faced emotional criticisms by survivors. The survivors complained of such features of the Fund as the $250,000 cap on noneconomic damages. A New York City police officer whose wife died in the attacks told Mr. Feinberg at a meeting with victims, "I feel your offer spits on my wife, my mother-in-law and my father-in-law," saying that he had to watch his in-laws "pop pills just to get through the day."[30]

At the same time, criticism mounted from those vexed with what they considered the avarice of the victims' families. One viewer wrote an officer of

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23. Interim Final Rule, September 11th Victim Compensation Fund of 2001, § 104.2(a), 66 Fed. Reg. at 66,282.

24. *Id.* § 104.41, 66 Fed. Reg. at 66,286.

25. *Id.*

26. *Id.* § 104.43(c).

27. Final Rule, September 11th Victim Compensation Fund of 2001, § 104.44, 67 Fed. Reg. at 11,246.

28. Interim Final Rule, September 11th Victim Compensation Fund of 2001, § 104.63, 66 Fed. Reg. at 66,287.

29. *E.g.*, *CBS Evening News* (CBS television broadcast, Jan. 18, 2002).

30. Milo Geyelin, *Criticism of Sept. 11 Victims' Fund Sparks Backlash*, WALL ST. J., Jan. 23, 2002, at B1.

a victim advocacy group, "If $1.6 million isn't enough for you, then I hope you rot in hell."[31] Another letter writer said, "we feel your grief, really," but "I'm just wondering if we have to feel your greed, too."[32] A particularly graphic example of the almost tawdry mediaizing of the issue was a full color picture that occupied most of the front page of the *Chicago Sun-Times*. The photograph was of sixteen women, pregnant on September 11, whose husbands died in the attacks.[33] These widows, most of them smiling broadly with their infants in their arms, appeared surrounding a radiantly smiling Diane Sawyer, anchor person for ABC. A Chicago computer consultant, interviewed by a reporter on State Street, declared that "a little bit of this is becoming a money grab. . . . How you die and when you die is somehow becoming worth more money. I don't think we're giving $1.6 million to the families of soldiers killed in Afghanistan."[34]

Even within the narrow topic addressed here, Osama Bin Laden had created a problem for Solomon. Indeed, it was one that went far beyond deciding what to do with one baby in a controversy between two women. It required a consideration of the traditional rationales of tort law, of the bases for fashioning specialized compensation systems, and of the overarching problem of how society should respond to misfortunes generally.

V. THE GOALS OF LAW AND POLICY

When we analyze policy questions both molar and molecular,[35] our scholarly traditions teach us to look for the major premise. What are the goals of law and policy in determining society's responses to the attacks of September 11? One orthodox form of analysis indicates that a principal goal of injury law is the control of behavior that creates risks. Interestingly, the deterrence function indirectly provided by the statute requires initiation by claimants who elect to bring private actions. If one assumes that allowing suits against carriers and their agents would lead to efficient levels of risk-taking, the statute creates an intriguing wrinkle on the usual criticism of the "negligence lottery." In this context, any social dicing will depend upon the decisions of individual claimants to seek compensation from the fund or to exercise their common law rights to sue the airlines.

It is relevant here to refer to the very first section of the overall statute, which, as noted, is called the Air Transportation Safety and System Stabilization Act, and of which Title I is labeled "Airline Stabilization."[36] That section provides for federal compensation for air carriers, implemented by the President,

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31. *Id.*

32. *Id.*

33. *Victims' Families Face Backlash*, CHI. SUN-TIMES, Jan. 24, 2002, at 1.

34. Art Goleb, *Victims Fund Raises Ire*, CHI. SUN-TIMES, Jan. 24, 2002, at 18.

35. Justice Holmes penned this dichotomy in *Southern Pacific Co. v. Jensen*, 244 U.S. 205, 221 (1917) (Holmes, J., dissenting).

36. Air Safety Act, Pub. L. No. 107-42, 115 Stat. 230 (2001).

"in an aggregate amount equal to $5,000,000,000 for direct losses incurred beginning on September 11th, 2001, by air carriers as a result of any Federal ground stop order"[37] and subsequent orders of that sort. This amount also covers "the incremental losses incurred beginning September 11, 2001, and ending December 31, 2001, by air carriers as a direct result of such attacks."[38] Thus, typifying a public choice approach, Congress pays off the airlines for their misfortunes as a result of the attack; under the same statutory roof, it also leaves open a litigation avenue for injured persons and survivors that presumably would have the incidental result of making the airlines more careful.

The legislation manifests several specific purposes. But intuition suggests that, fashioned in the emotional aftermath of the attacks, the statute also reflects an unfocused desire to strike out against a particularly awful set of life's misfortunes, events burdening the national soul with a recognition that retribution is not available on behalf of the victims—or the nation—in any tit-for-tat manner. The statute is thus both a symbol of displaced vengeance and a marker of social compassion. At the very outset of the Special Master's statement attached to the Interim Final Rule for the Fund, he refers to the Fund as "an unprecedented expression of compassion on the part of the American people to the victims and their families devastated by the horror and tragedy of September 11."[39]

The use of law—any kind of law—as a deterrent is imprecise at best.[40] Because of that inexactitude, dependence on deterrence as the centerpiece of tort rationales constantly runs the risks of both under- and over-deterrence. Those difficulties find a close parallel within injury law in problems of under- and over-compensation. In traditional analysis, fairness of compensation is the other principal pillar of injury law alongside deterrence. Suits against the carriers, in the view of some, would provide some corrective justice in favor of the victims and survivors. However, the enactment of the compensation legislation obviously is aimed at fairness in the round—at a kind of distributive justice in a situation where the concept of justice is multifaceted.

In theory, Congress might have begun the legislative process by viewing itself as a think tank, dedicated to cogitating on the human toll of the attacks in the broad context of how society allocates life's burdens, including the burdens of death and injury in general. However, Congress did not have that meditative luxury. Even if it had, it would have been sensitive to the problem of the Tsar; Congress would have recognized that it is not at all likely that it will enact a fully

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37. *Id.* § 101(a)(2)(A).

38. *Id.* § 101(a)(2)(B).

39. Interim Final Rule, September 11th Victim Compensation Fund of 2001, Statement by the Special Master, 66 Fed. Reg. 66,274, 66,274 (Dec. 21, 2001) (to be codified at 28 C.F.R. pt. 104).

40. *Cf.* Moisan v. Loftus, 178 F.2d 148, 149 (2d Cir. 1949). In this opinion, which implicitly emphasizes the limits of the formula in *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947), Learned Hand notes the "illusory" nature of quantitative estimates of the factors most often crucial to issues of negligence. I am grateful to Chris Montroy for calling this case to my attention.

articulated, comprehensive compensation system for all kinds of misfortune. Therefore, in deciding to allocate federal funds to the victims, Congress made a pragmatic decision to carve out these particular events from all the rest of life's misfortunes for which some remedy can be provided by dollars. In this regard, it is noteworthy that the victim compensation part of the statute "constitutes budget authority in advance of appropriations Acts and represents the obligation of the Federal Government to provide for the payment of amounts for compensation under this title."[41]

With respect to those who choose to take advantage of federal funding and thus to waive any tort actions, Congress made a number of rough-and-ready judgments. These judgments reflect many of the cross-currents that run through our law of injuries, including the common law of torts and the development of statutory compensation systems.

The decision to enact a no-fault system is one of the most important of these choices. We should note the contrast between this no-fault scheme and that of workers' compensation. Even at the time that the states adopted the workers' compensation model to deal with the problem of industrial injuries, there was at least a real possibility of a tort action against a known defendant who was directly responsible for the injuries in question. By comparison, any fault of potential domestic defendants in the case of the September 11 attacks is a fault that derives only from the crimes of third parties who are either dead or extremely elusive.

The decision to leave to claimants the choice of an assured compensation payment from federal funds or the gamble of a torts suit is not a unique one,[42] although this surely is not the approach of the workers' compensation model. Again, the comparison with that system is interesting. Workers' compensation is in the main an exclusive remedy, with its exclusivity justified on the basis of a well known quid pro quo: plaintiffs give up the tort action, tied as it is to the handicaps of contributory negligence and assumption of risk, in exchange for a relatively assured, if often less lucrative, payment. By comparison, the Fund legislation offers legal consumerism in the hyper mode. Although the suit against the carriers is an exclusive remedy within the category of civil actions, it is only one of two full alternative remedies. Wildly differing metaphors may apply: the consumer gets to play one of two games available in the casino or gets to pick from either of two sections of the supermarket. These crass presentations of the issue simply underline the leeway to indirectly influence the choice of social policy that Congress has given to potential claimants.

In addition to the straight subsidy provided to the airlines for both direct and incremental losses, and the compelled waiver of civil actions imposed on those who elect compensation from the Fund, the carriers received yet another benefit from the Fund section of the legislation. This is the provision on liability actions

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41. Air Safety Act § 406(b).

42. *See, e.g.*, Allison v. Merck & Co., 878 P.2d 948, 960-61 (Nev. 1994) (allowing tort suits for vaccine-caused injuries despite the National Childhood Vaccine Injury Act of 1986, 42 U.S.C. § 300aa-11 (Supp. 1992)).

that caps "liability for all claims, whether for compensatory or punitive damages" at the "limits of the liability coverage maintained by the air carrier."[43] That provision is an anomaly where traditional tort law is concerned. In fact, it is a very different kind of cap than those that typically appear in tort reform legislation and proposals, which focus on damage amounts for noneconomic losses and punitive damages. Those types of caps essentially define, if arbitrarily, what losses are. By comparison, the Fund legislation implicitly acknowledges that legally recognized losses may be greater than insurance coverage but makes a public choice that is in essence a direct subsidy.

The usual stance of tort law, in current slang, has been that entities that are careless on a large scale "deserve to die." Illustrative are the bankruptcies of many asbestos companies as well as of the maker of the Dalkon Shield. But for a variety of policy reasons, Congress in this statute enacted the view that the airlines deserved to live even if they were careless; indeed, Congress in effect said that they must live, for the health of the nation.

Another interesting feature of the Fund legislation is the breadth of its definition of the collateral sources that must be deducted from payments by the Fund. Particularly striking is the inclusion of life insurance in the definition of deductible collateral sources, a choice that goes beyond traditional definitions of such payments. Giving especially sharp point to Congress' decision to deduct collateral sources and to deduct them so broadly—and its apparent premise for doing so—is the Special Master's explication of the definition of economic loss. He paraphrases the Rules as mandating that his "schedules, tables, or charts should identify presumed determinations of economic loss up to a salary level commensurate with the 98th percentile of individual income in the United States."[44] He comments that "[a]ny methodology that does nothing more than attempt to replicate a theoretically possible future income stream would lead to awards that would be insufficient relative to the needs of some victims' families, and excessive relative to the needs of others."[45] He also notes specifically that the requirement in the Act that he

> consider "the individual circumstances of the claimant" indicates that the Special Master may consider a particular claimant's financial needs and resources, just as the Department [of Justice] and the Special Master considered the needs of claimants in concluding that no claimant bringing a claim on behalf of a deceased victim should receive less than $500,000 or $300,000 before collateral source offsets.[46]

Congress, the Rules, and the Special Master thus all accept the proposition that social fairness requires taking need into account. But need is defined, in true

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43. Air Safety Act § 402(4).

44. Interim Final Rule, September 11th Victim Compensation Fund of 2001, Statement by the Special Master, 66,274, 66,278 (Dec. 21, 2001) (to be codified at 28 C.F.R. pt. 104) (paraphrasing § 104.43(a)).

45. *Id.*

46. *Id.*

capitalist style, as related closely to income levels. Illustratively, before collateral offsets, the payments to survivors of a married victim who died at thirty-five with two dependent children would total $613,714 if he was earning $10,000, but would be $3,805,087 if he was earning $225,000.[47] For a single decedent who was thirty-five and earning $10,000 when she died, the payments—again before collateral offset—would be $312,083, but they would be $2,189,311 for someone earning $225,000.[48]

These raw numbers are excellent examples of the reasons for the canker of critical legal scholars about the inegalitarian nature of tort damages.[49] However, the Rules do make a small bow to feminist analysis in providing that for non-earners, the Special Master may consider "replacement services and similar measures."[50] The bow is a restrained one because at least in their terms, the Rules do not take into account the opportunity cost of homemakers who would net more money by putting their children in day care while they more fully realize their earnings potential.[51]

The Rules make a clear set of choices about the dollar value of feelings and of life generally. Perhaps the most interesting of these is the presumption of a $250,000 value for the noneconomic loss of decedents and an additional $100,000 for that of spouses and dependents. Those familiar with the cases involving pre-impact fear of persons killed in air crashes will understand that this appears to be exceptionally generous with respect to the awful final moments of the decedents.[52] By contrast, the Rules seem relatively stingy with respect to the affective losses of survivors. These arbitrary choices simply illustrate the incoherency—perhaps the necessary incoherency—of our theories of tort damages, especially damages for intangibles. Underlining the difficulty of quantifying affective relationships in precise dollar amounts is the change of the awards for spouses and dependents from $50,000 in the Interim Final Rule to $100,000 in the Final Rule.[53] The explanation is laconic, as it almost had to be: "After reviewing the public comments and meeting with numerous families of victims, we have decided to double that amount to $100,000 for the spouse and each dependent."[54]

Related benchmarks are the overall compensation minimums of $500,000 for

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47. *Id.* (Charts of the Special Master).

48. *Id.*

49. *See, e.g.*, Richard L. Abel, *A Critique of Torts*, 37 UCLA L. REV. 785, 799 (1990) ("[t]ort damages deliberately reproduce the existing distribution of wealth and income").

50. Interim Final Rule, September 11th Victim Compensation Fund of 2001, 66 Fed. Reg. at 66,286.

51. I am grateful to Martha Chamallas for remarks that led to this observation.

52. *See, e.g.*, Haley v. Pan Am. World Airways, 746 F.2d 311, 317-18 (5th Cir. 1984) (affirming $15,000 award "for no more than four to six seconds of . . . anguish").

53. *Compare* Final Rule, September 11th Victim Compensation Fund of 2001, 67 Fed. Reg. 11,246 (Mar. 13, 2002) (to be codified at 28 C.F.R. pt. 104), *with* Interim Final Rule, September 11th Victim Compensation Fund of 2001, 66 Fed. Reg. 66,286.

54. Final Rule, September 11th Victim Compensation Fund of 2001, 67 Fed. Reg. at 11,239.

decedents with spouses or dependents and $300,000 for single decedents with no dependents. These are themselves arbitrary figures that could be criticized as too low; few would have the temerity to say that they are too high. What is significant is that they appear to codify a general belief that for a variety of reasons, stated and mostly unstated, the existence of a life itself has financial value. It is interesting in this connection that Congress, perhaps casually, specifically included the currently controversial concept of "hedonic damages" in the definition of "noneconomic losses."

It is worth noting, at least incidentally, that the statutory references to those eligible for compensation do not appear to be rigorously logical. One may compare, in this regard, the statement of congressional purpose "to provide compensation to any individual (or relatives of a deceased individual) who was physically injured or killed" in the attacks[55] with the definition of the category of eligible individuals as including "the personal representative of the decedent who files a claim on behalf of the decedent."[56] There appears to be a mixture here of traditional concepts of wrongful death and survival, but this is surely not unique in our existing state law.

CONCLUSION

The Fund legislation, and the losses that generated it, house many of the central arguments about how society should deal with injuries. In particular, they raise in a very emotional context the cross-equity problem among all kinds of injuries and misfortune more generally. From a social point of view, how do we distinguish the deserts of those who slip in the bathtub from those injured in the "second collision" of an allegedly uncrashworthy automobile? More relevantly, how do we distinguish those individuals from the firemen who were headed up into the Twin Towers as everyone else was coming down, and American soldiers who die from either hostile or friendly fire in Afghanistan?

Tort law provides only interstitial answers, and those only to the first referenced pairing of victims, and Congress, as we have noted, is not likely to provide a comprehensive solution that encompasses all the cases. With no Tsar to place the issues in a general framework and settle them globally, the equity profile of compensation is a jagged one. On this battleground, symbolic disputants are the man who claims that a cap of a quarter of a million dollars on the intangible losses of his wife spits on her memory, and the person who accuses survivors of greed. And that battleground is a political one.

In creating the Fund, Congress tried to broker the politics of injury. What are we to make of this legislative patchwork, hastily constructed with the noblest intentions? Unlike the thoroughgoing New Zealand scheme, the Fund legislation carves out a narrow wedge of misfortune. Limited as it is to the relief of victims of events occurring in just three places on a single morning, the statute even contrasts with the workers' compensation laws and the varied no-fault statutes

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55. *Id.* § 403.

56. *Id.* § 405(c)(2)(C).

for motor vehicle accidents. All of those statutes embrace injuries that occur every day throughout their jurisdictions.

There will be many different interpretations of why, out of the broad spectrum of possible responses, Congress chose to create this Fund with its distinct provisions. Surely some of the distinguishing features of September 11th that led our national legislature to this solution include the unique occasion of an attack on the continental United States that caused thousands of deaths and the repetitively broadcast television images of the events. Even the instigating cave-dwellers of Afghanistan saw—as we all did—the crashes, the fire and the smoke as they rolled along miles of videotape.

Let me compare the day of the attack on Pearl Harbor, at the edge of my memories of boyhood. Without plumbing the comparative impact of print, radio, and television, I think that we can say that the events of September 11 turned out to be a quintessential television occasion. That would have been so even if those events had not been made for television, though it appears that in a very real sense their diabolical instigators planned them that way. By contrast, Americans who saw films of the attack on Pearl Harbor saw them, if at all, in newsreels in theaters. Moreover, Hawaii was not a state at that time and, in any event, was 2500 miles away from the country as it then was constituted. The attack on the continental United States in 2001 aroused many feelings, but one response that stands out and is manifested in the Fund legislation—and is further magnified by the subsequent anthrax cases—is a new sense of national vulnerability.

All of this has led to a unique form of public choice. Responding to a most tragic set of circumstances, the legislation has something for everyone. Specifically as to the airlines, it pays them off, it limits their liability in any event, and it offers them a potential immunity—remarkably, one conferrable by choices made by victims and survivors. All this it does while compensating a wide range of losses for those victims and survivors from the general revenues.

Finally, the legislation and the Rules provide a certain balm for us all, in our continuing horror at the events, our collective compassion for the victims, and our increased sense of vulnerability. The film clips and reports of the discussions that a sometimes beleaguered Special Master has had with the survivors present a continuing drama that would be as familiar to Tocqueville as to devotees of soap operas. After the accelerated fashioning and passage of the statute and the speedy drafting of the rules with the Special Master's explication, we are only in an intermediate stage of that drama. Now we appear to be witnessing a nationwide community conversation about the limits of compassion, the sharing of burdens, and even the vices of greed and envy.

A byproduct of the Fund statute is its teaching about the limits of traditional economic analysis. Perhaps the most noteworthy feature of the Fund legislation is its most obvious feature: the commitment of federal money for the relief of victims of what was not only perceived domestically as an attack on us all, but was intended to be perceived that way. Churchill, perhaps the greatest figure of the twentieth century in light of his combined accomplishments, captured the core of the situation with his characteristic eloquence, concision and humanity. In his war memoirs, he describes how his insistence on a national insurance scheme for bomb damage arose from his view of a demolished restaurant in

Margate:

> The proprietor, his wife, and the cooks and waitresses were in tears. Where was their home? Where was their livelihood? Here is a privilege of power. I formed an immediate resolve. . . . I dictated a letter to the Chancellor of the Exchequer laying down the principle that all damage from the fire of the enemy must be a charge upon the State and compensation be paid in full and at once.[57]

Churchill observed that it was essential to the political success of this scheme that the public and Parliament were willing "to separate damage resulting from the fire of the enemy from all other forms of war loss."[58] He added, "it would be a very solid mark of the confidence which after some experience we are justified in feeling about the way we are going to come through this war."[59]

There are, of course, differences in both the events and the responses. But as a general description of the politics and the policy of this specialized jurisprudence of injury, the words of the master are resonant. The Fund forges a linkage, one beyond the graphs of microeconomic theory, among tens of millions of souls. Besides the survivors, these include—only illustratively—my student with her acquaintance on the Pennsylvania plane, my student with the orthodontist's appointment in New York, and my sons and their friends and colleagues, living and dead.

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57. WINSTON CHURCHILL, THEIR FINEST HOUR 349 (1949).

58. *Id.* at 350.

59. *Id.*

A PIG IN A PYTHON: HOW THE CHARITABLE RESPONSE TO SEPTEMBER 11 OVERWHELMED THE LAW OF DISASTER RELIEF

ROBERT A. KATZ*

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* Associate Professor of Law and Philanthropic Studies, Indiana University School of Law—Indianapolis and the Center on Philanthropy at Indiana University. My deepest thanks to Professor Warren Schwartz for inviting me to present this paper at the conference on "The Law and Economics of Providing Compensation for Harm Caused by Terrorism," which was sponsored by the John M. Olin Program in Law and Economics and held at the Georgetown University Law Center on April 19 and 20, 2002, and for his constant encouragement and sage advice. Thanks also to Victoria Bjorklund, Evelyn Brody, Dan Cole, Nicholas Georgakopoulos, Mark Harris, Lawrence Jegen, Florence Roisman, and George Wright for their helpful comments. Faith Long Knotts, Miriam Murphy, Janet Gongola, and Andrew Dutkanych provided excellent research assistance.

INTRODUCTION

The terrorist attacks of September 11, 2001 ("9/11") inspired an unprecedented amount of charitable giving while imposing extraordinary burdens on the charities that received these gifts. It is generally thought that donors outperformed charities at their respective tasks. An estimated two-thirds of American households donated money to charities engaged in 9/11 relief,[1] and thirty-five of the largest donee charities raised almost $2.7 billion.[2] The response

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1. *AMERICA GIVES: Survey of Americans' Generosity After September 11*, Center on Philanthropy at Indiana University, *available at* http://www.philanthropy.iupui.edu/AmericaGivesReport.htm (last visited Oct. 5, 2002) (In a telephone survey conducted from October 22 to November 28, 2001, 65.6% of 1304 adults reported that they or their households had contributed money for 9/11 victims.).

2. U.S. General Accounting Office, *September 11: More Effective Collaboration Could Enhance Charitable Organizations' Contributions in Disasters*, GAO-03-259 at 7-8 (Dec. 2002) [hereinafter U.S. GAO, *September 11 Report*], *available at* http://www.gao.gov/new.items/d03259.pdf (last visited Feb. 14, 2003). By comparison, the 1995 bombing of the Murrah Federal Building

of donors was widely hailed as evidence of the American people's virtue and resilience. Some of the most prominent charities receiving these gifts, on the other hand, were criticized for not getting aid to victims fast enough, and for allegedly attempting to use donations for purposes unrelated to 9/11 relief, contrary to their own representations and their donors' intentions. "It has now become something of a scandal," wrote a *Wall Street Journal* columnist two months after the attacks, "that so little of [the American people's] benevolence has been disbursed. The givers are asking how this could be."[3] This Article undertakes to answer that question from a legal perspective: What underlay the allegations of delay, disloyalty and misrepresentation? What did the charitable response to the attacks reveal about charity law? How, if at all, did the 9/11 experience affect this body of law, and how should it?

In many matters, the charities' problems were logistical rather than legal. Some organizations were simply not prepared for the tasks of collecting, accounting, committing, and distributing enormous sums of money in short order. The Salvation Army, for example, invited 9/11 victims to send it their household bills, and promised to pay their creditors directly. In order to manage the rush of bills, however, the charity needed to mail 1500 checks a day. Its technology for processing and writing checks, unfortunately, could initially produce only 100 checks a day.[4] As a result of unpaid bills, hundreds of families received late notices threatening cancellation of essential services, insurance policies, and even eviction.[5]

Yet some charities' difficulties went beyond mere logistics. These originated in part, this Article argues, in two latent tensions within the legal regime that govern charitable organizations in general, and disaster relief organizations ("DROs") in particular. Charities hold donations in trust or a trust-like arrangement whose terms are set by the donors and charities within the parameters established by charity law. This arrangement can be strained when donors demand or expect charities to act in ways that exceed the bounds of what is legally charitable. Another clash can occur when donors ask a charity to act at odds with its broader mission or principles. The outpouring of gifts to DROs following 9/11 exposed both these tensions on a grand scale.

The rules for disaster relief mirror what most people want and expect DROs to do most of the time. DROs typically deliver emergency goods, services,

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in Oklahoma City yielded $45 million in donations, and Hurricane Andrew, which struck southern Florida in 1992, inspired donations of around $110 million. *Charitable Contributions for September 11: Protecting Against Fraud, Waste, and Abuse, Hearing Before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce*, 107th Cong. 2 (2001) [hereinafter Greenwood hearing (after the subcommittee's chairman, U.S. Representative James Greenwood (R-PA))].

3. Daniel Henninger, *Wonder Land: Charity Begins at Home, Ends Up Nowhere*, WALL ST. J., Nov. 16, 2001, at A12.

4. Diana B. Henriques, *Charity Overwhelmed in Bid to Meet Attack Victims' Bills*, N.Y. TIMES, Jan. 5, 2002, at A1.

5. *Id.*

shelter, and other forms of in-kind relief. Such aid can be provided to all who suffer distress under the circumstances, regardless of their overall financial condition.[6] Stricter rules apply, however, when DROs make monetary payments to victims for intermediate and longer-term needs.[7] Generally speaking, such payments may only be made to ensure that a victim can procure the basic necessities,[8] and only after a specific assessment of the applicant's need.[9] After a very large, dramatic or high-profile disaster, some donors display uncommon generosity in their willingness and capacity to give. On such occasions, DROs may receive more money than is required to satisfy basic needs, and face pressure to spend everything raised on that particular disaster's victims.[10] Yet a DRO's managers[11] cannot succumb to this pressure without violating the legal bar against using charitable dollars to bestow private benefit.[12] Deciding how to dispose of the surplus can place these managers in a difficult position, one laden with legal and ethical challenges.

The controversies involving 9/11 relief followed one of two basic trajectories based on the type of charity involved: whether it was created solely to assist victims of 9/11 (a.k.a. "9/11-specific" or "disaster-specific" DROs), or to help the victims of certain categories of recurring disasters and emergencies (a.k.a. "general" or "multi-disaster" DROs). Both types of entities struggled to meet simultaneously the demands of donors, victims, the broader public, interested officials and charity law. Among 9/11-specific charities, the problems were most severe for those created exclusively for the families of firefighters, police officers, and other fallen rescue workers. These groups raised the most money per victim, and thus faced the greatest risk of making legally excessive payments. The Twin Towers Fund, for example, raised at least $440,640 for each of the 438 uniformed and other official personnel killed at the World Trade Center

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6. *See infra* notes 118-21 and accompanying text.

7. *See infra* notes 122-32 and accompanying text.

8. DROs usually provide in-kind relief, Rob Atkinson has observed, "under circumstances when there can be little doubt that the recipients would use monetary payments to buy precisely the same kinds of basic goods and services, if they were available." Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 524 (1990). Conversely, DROs can make monetary payments under circumstances when victims can buy the types of goods and services that DROs typically provide in-kind, and to victims who will undoubtedly use the cash to make such purchases, as opposed to, say, luxury goods.

9. Victoria B. Bjorklund, *Reflections on September 11 Legal Developments*, *in* SEPTEMBER 11: PERSPECTIVES FROM THE FIELD OF PHILANTHROPY 26 ("if donors did not want charities to administer aid by determining relative need, donors could instead give relief funds to private trusts managed by banks or mutual fund managers"; private trustees would not be so constrained).

10. *See, e.g.*, *infra* notes 200-16 and accompanying text.

11. I use the term "managers" to refer collectively to both the charity's governing body (trustees in a charitable trust, the board of directors in a charitable corporation) and its officers (executive director, chief financial officer, etc.).

12. *See infra* notes 88-105 and accompanying text.

("WTC").[13] The New York Firefighters 9-11 Disaster Relief Fund raised at least $418,000 for each of the 347 fire department personnel killed at the WTC.[14] In the months following the attacks, these charities feared that they could not disburse everything raised without violating charity law principles.[15]

General DROs engaged in 9/11 relief included the American Red Cross and two union-run "widows' and children's funds" for the families of fallen firefighters and police officers. Unlike 9/11-specific charities, these entities did not unequivocally promise to spend everything raised after the attacks on 9/11 victims, and many of their donors did not expressly restrict their gifts to that purpose. In these circumstances, issues involving donor intent became murkier. General DROs bore the added burden of reconciling their 9/11 relief activities with broader missions to treat similarly situated victims of different disasters in an even-handed manner. On some level, these organizations' moral identities were threatened by the prospect of providing one disaster's victims with vastly more aid per capita than similarly situated victims of other disasters. Each type of DRO thus faced a distinct dilemma: 9/11-specific DROs wondered if they *could* spend everything raised on 9/11 relief, while general DROs wondered whether they *had* to. The dilemma faced by 9/11-specific charities was not resolved until Congress intervened, *deus ex machina*, by expressly authorizing them to assist victims without regard to financial need.[16] Some general DROs concluded that they did not; others concluded that it would be wise to do so, even if the law did not require this.

This Article proceeds as follows: Part I discusses principles of charity law relevant to our analysis, especially the distinction between charitable versus benevolent but legally non-charitable purposes, the bar against private benefit, the rules governing the disposition of surplus funds, and the special principles that apply to disaster relief activities. Part II examines the legal challenges that confronted some 9/11-specific charities as they tried to disburse large sums to relatively few victims. Part III relates explores the experiences of several general charities that sought to use some post-attack donations for purposes other than 9/11 relief. The concluding section considers how these events may affect the charitable response to future high-profile disasters.

I. BOUNDED GENEROSITY: LEGAL LIMITS ON A CHARITY'S ABILITY TO ASSIST DISASTER VICTIMS

DROs operate within a legal framework derived from the common law of charitable trusts, key principles of which have been carried over into the state law of nonprofit corporations and the federal law of tax-exempt organizations. This

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13. *Twin Towers Fund*, *at* http://www.twintowersfund.org (last visited Feb. 22, 2003).

14. Tom Seessel, The Philanthropic Response to 9/11: A Report Prepared for the Ford Foundation 41 (Aug. 2002), *available at* http://www.fordfound.org/publications/recent_articles/philanthropic_response.cfm (last visited Feb. 12, 2003).

15. *See infra* notes 236-40 and accompanying text.

16. *See infra* notes 273-83 and accompanying text.

section examines some key principles of this body of law (a.k.a. "charity law") and how they apply to disaster relief activities.

A. Charitable Trusts and the Duty to Honor Donor Intent

The typical trust is created when one party (a.k.a. the settlor or donor) transfers or donates property to a second party, a trustee, for the benefit of a third, the beneficiary.[17] The primary duty of any trustee is to carry out the terms of the trust insofar as these are lawful and communicated to the trustee.[18] The settlor typically but not always spells out these terms in written instructions that accompany the gift.[19] By accepting the gift, the trustee obliges itself to comply with the settlor's instructions as transmitted. A somewhat different rule holds when the trustee appeals to the public for contributions. Absent additional instructions from the settlor, the trust's terms are contained in the trustee's representations and the circumstances surrounding the gift.[20]

The private trust and the charitable trust are the two most familiar types of this arrangement: they share many features, but differ in some key respects. To be valid, a private trust must benefit definite persons whose identities are either presently known or ascertainable within the period set by the Rule Against Perpetuities.[21] That rule sets the outer limits on a private trust's duration—roughly a century.[22] A charitable trust, by contrast, typically benefits

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17. The settlor and the trustee can be the same person; this occurs when a settlor declares himself trustee of specific property for the benefit of another without transferring the property to someone else to serve as trustee. PAUL G. HASKELL, PREFACE TO WILLS, TRUSTS AND ADMINISTRATION 75-76 (2d ed. 1994). I focus exclusively on trusts involving three parties.

18. RESTATEMENT (SECOND) OF TRUSTS § 4 & cmt. a; § 169; § 379 & cmt. a (1957) ("The trustees of a charitable trust . . . are subject to duties . . . to administer it solely in the interest of effectuating the charitable purposes . . . ."); SCOTT ON TRUSTS § 164.1 (William F. Fratcher ed., 4th ed. 1986) [hereinafter SCOTT]; L.A. SHERIDAN, KEETON & SHERIDAN'S THE MODERN LAW OF CHARITIES 349 (4th ed. 1992); JEAN WARBURTON & DEBRA MORRIS, TUDOR ON CHARITIES 245 (8th ed. 1995).

19. *See, e.g.*, LSU Foundation, *Certificate of Donor Intent* (form for donor to specify and confirm purpose of donation), *available at* http://www.fas.lsu.edu/AcctServices/forms/far/certintent.pdf (last visited Oct. 16, 2002); *see also* Indiana University Foundation, Policies/Procedures, *Donor's Intent—Policy Governing the Application of* (in construing donor intent, "[i]nterpretation shall be based primarily on any legal documents received, including but not limited to a will, trust, gift agreement or court order." Other probative sources may include: past correspondence from donor, notes from telephone or in person conversations with the donor, or correspondence from donor's family, attorney, executor, etc.), *available at* http://iufbusiness.iu.edu/admin/policies/Policy-Governing-the-Application-of-Donors-Intent.html.

20. *See, e.g.*, Loch v. Mayer, 100 N.Y.S. 837, 841-42 (Sup. Ct. 1906).

21. HASKELL, *supra* note 17, at 173-76. In its common law formulation, the rule holds that no future interest in property is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest. *Id.* at 174.

22. Rob Atkinson, *Reforming Cy Pres Reform*, 44 HASTINGS L.J. 1112, 1114 & n.8 (1993).

an open-ended class of persons or the public generally, and can last indefinitely.

Charitable trustees violate their duties by failing to spend a donor's gift in accordance with the gift's instructions so long as these are feasible and legally charitable.[23] Breach can occur when trustees impound funds that they are obliged to spend to the beneficiaries' advantage.[24] It can also occur when trustees use funds restricted for one purpose to advance another purpose without first obtaining judicial approval[25] or, in some circumstances, the donor's consent.[26] Trustees who fail to use gifts for the represented purpose may also be liable for fraud, misrepresentation, or false advertising.[27]

Although private and charitable trustees have comparable duties, the mechanisms for enforcing these duties differ. In the typical private trust, only the beneficiary can bring suit to enforce the trustee's duties.[28] A charitable trustee's duties, by contrast, are usually enforced only at the suit of the state attorney general.[29] Although the public is ostensibly the charitable trust's ultimate beneficiary, it is thought that permitting any citizen to bring an enforcement suit would produce frequent, unreasonable and vexatious litigation.[30] Parties that can demonstrate a "special interest" in the trust's performance (i.e., one distinct from the generic citizen's) can also maintain a suit to enforce it.[31] A party can establish such an interest by, inter alia, demonstrating that she is entitled to receive a direct benefit under the trust's terms.[32] This is easier to do where the

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23. WARBURTON & MORRIS, *supra* note 18, at 245 & nn.90-91.

24. RESTATEMENT (SECOND) OF TRUSTS § 182 (1957). *See also* Greenwood hearing, *supra* note 2, at 40 (Spitzer) ("if a[charitable] entity . . . were merely letting funds sit in a bank account without being distributed at all, [the state attorney general's office] of course, would take appropriate action").

25. WARBURTON & MORRIS, *supra* note 18, at 245.

26. *See, e.g.*, Carl J. Herzog Found., Inc. v. Univ. of Bridgeport, 699 A.2d 995 (Conn. 1997) (under section 7(a) of the Uniform Management of Institutional Funds Act, an institution can release a restriction the donor imposed in his gift instrument with the donor's written consent).

27. *See, e.g.*, N.Y. EXEC. LAW § 172-d(2) & (3) (consol. 2002) (prohibiting charities from making false or materially misleading statements or using false advertising while soliciting for charitable donations); Marcus v. Jewish Nat'l Fund, 557 N.Y.S.2d (App. Div. 1990) (charities may be sued for false advertising under general business code); 73 AM. JUR. 2d *Subscriptions* § 17 (1974) (to sustain a charge of fraudulent charitable solicitation, it must be shown that the solicitor misrepresented a material fact related to the subject matter of the gift).

28. RESTATEMENT (SECOND) OF TRUSTS § 112 (1957).

29. *See* BOGERT'S TRUSTS AND TRUSTEES § 411 (rev. 2d ed. 2001) [hereinafter BOGERT'S]; RESTATEMENT (SECOND) OF TRUSTS § 391 (1957). A trustee or director can also bring an action against the other trustees or directors to enforce a charitable trust or on behalf of a charitable corporation; JAMES FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS 259 (2d ed. 2000).

30. BOGERT'S, *supra* note 29, § 411.

31. RESTATEMENT (THIRD) OF TRUSTS § 28 cmt. c (Tentative Draft No. 2, 1999).

32. RESTATEMENT (SECOND) OF TRUSTS § 391 cmt. c (1957).

trust defines its immediate beneficiaries with precision.[33] For example, if a charitable trust is created to benefit the poor members of a particular church, any member of the church meeting this description has standing to sue the trustees.[34] A donor generally lacks standing to sue unless she expressly retains it in the terms of her gift. Alternatively, the donor may reserve a right of reverter, which enables her to regain possession of the gifted property if the donee breaches the trust.[35]

Some have argued that limited standing results in too little supervision of charities. Because many charitable trusts produce diffuse benefits such as world peace and clean air, no discrete person can demonstrate a *special interest*. As for attorney general supervision, "[s]taffing problems and a relative lack of interest in monitoring nonprofits makes [such] oversight more theoretical than deterrent."[36] Yet this is not necessarily or always a bad thing. Lax enforcement of donor restrictions can give trustees the leeway to use a charity's resources more efficiently, equitably or creatively—breach of trust notwithstanding.[37] Consider a charity that solicits funds for victims of disaster A. If it raises $100 million for this purpose, the trustees may violate their trust by unilaterally holding $1 million in reserve for future disasters. Even so, the attorney general may not object if she concludes that this action on balance serves the public interest.[38] In this case, her passivity may be a virtue.

In the United States, donors tend to use nonprofit corporations to manage and administer charitable gifts.[39] There is some ambiguity and even confusion as to

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33. *Id.*; BOGERT'S, *supra* note 29, § 414; SCOTT, *supra* note 18, § 391.

34. RESTATEMENT (SECOND) OF TRUSTS § 391 cmt. c (1957).

35. Some donors expressly reserve a right of reverter, which enables them to regain possession of the donated property if the donee breaches the terms of the gift. Such donors can thereby establish a special interest in the donee's compliance. Carl J. Herzog Found., Inc. v. Univ. of Bridgeport, 699 A.2d 995, 997 (Conn. 1997).

36. FISHMAN & SCHWARZ, *supra* note 29, at 257.

37. In determining whether a charity's alternate but legally unauthorized use of a gift is on balance more efficient, one must factor in the negative effects of breach on the willingness of people to contribute to that charity in the future, or to charitable organizations in general. This is an act-utilitarian inquiry. A rule-utilitarian would argue that "experience shows that it doesn't pay to break a promise. Donors will lose confidence in the organization, the cause will suffer for loss of financial support, and the public good for the greatest number will not be well served." ALBERT ANDERSON, ETHICS FOR FUNDRAISERS 53 (1996). A non-consequentialist would reject the entire inquiry as amoral: The charity has an ethical duty to keep its promise to the donor. *Id.*; *see also* Atkinson, *supra* note 22, at 1111 (stating that control over donated assets should ultimately be placed in the hands of each donee charity's directors, subject neither to legally enforceable donor control nor to judicial modification on efficiency grounds; this approach would strengthen the independence of the nonprofit sector, and thereby promote pluralism and diversity in society).

38. *See, e.g.*, *Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means*, 107th Cong. 55-56 (2001) (statement of Eliot Spitzer, New York State Attorney General).

39. BOGERT'S, *supra* note 29, § 362.

whether the corporate recipient is a formal "trustee,"[40] and the extent to which trust principles apply to gifts not denominated as "trusts."[41] Whatever the arrangement is called, however, a charitable corporation that receives a gift for a particular purpose, must generally apply the property to that purpose,[42] at least in the first instance.[43] Even when a corporation receives an outright or unrestricted gift, it can only use the property to advance the organization's purposes or mission as set forth in its charter and by-laws.[44] In either case, the gift restrictions are enforceable at the suit of the attorney general.[45]

B. The Charitable Enterprise

To be legally charitable, a nonprofit organization must advance a charitable purpose, benefit a charitable class, and avoid bestowing excessive benefits upon private parties. These rules restrict the charity's lawful aims and activities and command its directors' compliance.[46]

1. Charitable Purposes.—Trust law distinguishes charitable trusts from private trusts, which can advance any purpose that benefits the beneficiary[47] and is not illegal or against public policy.[48] The charitable trust, by contrast, must promote purposes that the common law deems sufficiently and suitably beneficial to the general public.[49] This "public benefit" requirement reflects the view that

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40. *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 348 (1957); SCOTT, *supra* note 18, § 348.1 ("The truth is that it cannot be stated dogmatically that a charitable corporation either is or is not a trustee . . . It is probably more misleading to say that a charitable corporation is not a trustee than to say that it is, but the statement that it is a trustee must be taken with some qualifications.").

41. *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 348 (1957); SCOTT, *supra* note 18, § 348.1 ("The question is in each case whether a rule that is applicable to trustees is applicable to charitable corporations, with respect to unrestricted or restricted property. Ordinarily the rules that are applicable to charitable trusts are applicable to charitable corporations, as we have seen, although some are not.")

42. SCOTT, *supra* note 18, § 348.1.

43. I say "in the first instance" because different rules may govern the disposition of surplus from specific-purpose gifts to charitable corporations as opposed to charitable trusts. *See infra* notes 151-52 and accompanying text.

44. RESTATEMENT (SECOND) OF TRUSTS § 348 cmt. f (1957); BOGERT'S, *supra* note 29, § 362 & n.17. This is known as the "duty of obedience." DANIEL KURTZ, BOARD LIABILITY: A GUIDE FOR NONPROFIT DIRECTORS 21, 84-86 (1988).

45. RESTATEMENT (SECOND) OF TRUSTS § 348 cmt. f (1957).

46. FISHMAN & SCHWARZ, *supra* note 29, at 231 ("A nonprofit corporation and its directors and officers have the responsibility to comply with the law") (citation omitted).

47. RESTATEMENT (THIRD) OF TRUSTS § 27 2001(2) (Tentative Draft No. 2 1999) ("a private trust, its terms, and its administration must be for the benefit of its beneficiaries"); UNIFORM TRUST CODE § 404(c) (2000).

48. *See, e.g.*, UNIFORM TRUST CODE § 404 (2000).

49. Like private trusts, charitable trusts also may not pursue purposes that are illegal or violate established public policy. Bob Jones Univ. v. United States, 461 U.S. 574 (1983).

"charitable trusts are a drain on social resources and must therefore justify themselves on a societal level."[50] Special privileges accorded charities include the ability to endure indefinitely[51] and, in most cases, favorable tax treatment.[52]

Although legally charitable purposes often entail providing goods and services to "needy people who cannot pay for [the] benefits received,"[53] this is not a prerequisite.[54] Charitable purposes have traditionally been grouped under four headings: (1) relieving poverty; (2) advancing education; (3) advancing religion; and (4) promoting certain "other purposes beneficial to the community, not falling under any of the preceding heads."[55] Relieving human suffering and distress generally qualifies as a charitable purpose, even when it involves benefiting people who are not financially needy, such as providing free counseling to all victims of a terrorist attack. The relief of suffering and distress might be classified as either the broader category to which poverty relief belongs, or as an instance of "other beneficial purposes."[56] The Treasury Department regulations and the IRS seem to hold the former position.[57]

On the traditional view, writes Rob Atkinson, charitable entities can benefit the public in two main ways: "by providing goods or services that are deemed to be inherently good for the public," (e.g., education, health care); "or by delivering ordinary goods or services to those who are recognized as being especially needy," (e.g., food and shelter to the poor or otherwise disadvantaged).[58] A nonprofit elite prep school that charges the same astronomical tuition to all comers is an example of the former; its charitable

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50. Miriam Galston, *Public Policy Constraints on Charitable Organizations*, 3 VA. TAX REV. 291, 303 (1984).

51. *See supra* note 21 and accompanying text.

52. Trusts that qualify as "charitable" under the common law generally—but not necessarily—qualify for federal advantages. *See infra* notes 72, 501-02 and accompanying text.

53. BLACK'S LAW DICTIONARY (7th ed. 1999) (defining "charitable").

54. CARL ZOLLMAN, AMERICAN LAW OF CHARITIES 135 (1924) (quoting Pashal v. Achlin, 27 Tex. 173, 199 (1863)) ("[a]lthough the relief of the poor, or a benefit to them in some way, is in its popular sense a necessary ingredient in a charity, this is not so in view of the law").

55. *See* Comm'rs of Income Tax v. Pemsel, A.C. 531, 583 (1891) (per Lord MacNaghten) (identifying four principal divisions of charity); *see also* Bob Jones Univ. v. United States, 461 U.S. 574, 589 (1983) (noting that Lord MacNaghten's "restatement of the English law of charity . . . has long been recognized as a leading authority in this country").

56. *Compare* ELIZABETH CAIRNS, CHARITIES: LAW AND PRACTICE 3 (1988) (citing McGovern v. Att'y Gen. (1982) Ch. 321 (Slade, J.)) (the relief of poverty should be regarded as a subdivision of a wider class of charitable purposes "comprising the relief of human suffering and distress generally"), *with* D.W.M. WATERS, LAW OF TRUSTS IN CANADA 584-85 (2d ed. 1984) (trusts that aim to relieve deprivation and want without excluding the rich from its benefits should be categorized under the heading of other purposes "beneficial to the community").

57. *See* Treas. Reg. § 1.501(c)(3)-1 (defining the term "charitable" as used in I.R.C. § 501(c)(3) to include "[r]elief of the poor and distressed or of the underprivileged").

58. Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 STETSON L. REV. 395, 402 (1997).

status is unaffected by the fact that poor people are effectively excluded from attending.[59] One can restate this two-pronged approach to charitable status in terms of Abraham Maslow's "hierarchy of needs" theory.[60] Maslow famously posited five levels of human needs: (i) physiological, such as the need for food, water and warmth;[61] (ii) safety, especially during times of emergency;[62] (iii) social acceptance and belonging;[63] (iv) esteem;[64] and (v) "self-actualization."[65] The higher level needs, he argued, are "less urgent subjectively," and generally cannot be met until the lower level needs are satisfied.[66] Nonprofits that exist solely to satisfy basic physiological and safety needs tend to be charitable in the ordinary or generic sense of relieving poverty, suffering, and distress. Nonprofits that cater to our higher-level needs for personal growth and fulfillment are apt to be per se charitable as advancing "education," religion, etc.[67]

Critically, a trust can be legally *non*-charitable even though it promotes the happiness and well being of many or most of the public. This is especially true of the trusts that distribute cash or ordinary goods without considering the recipients' financial needs, and without advancing education, religion, or any other per se charitable goal.[68] Such trusts are sometimes referred to as "benevolent," as opposed to "charitable."[69] So, for example:

> [I]f a large sum of money is given in trust to apply the income each year in paying a certain sum to every inhabitant of a city, whether rich or poor, the trust is not charitable, since although each inhabitant may receive a benefit, the social interest of the community as such is not thereby promoted.[70]

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59. *See* RESTATEMENT (SECOND) OF TRUSTS § 371 cmt. c (1957).

60. ABRAHAM MASLOW, MOTIVATION AND PERSONALITY (1954).

61. *Id.* at 35.

62. *Id.* at 39.

63. *Id.* at 43-59.

64. *Id.* at 45.

65. "Self-actualization" describes a person's need to be and do that which she was born to do, e.g., "A musician must make music, an artist must paint, and a poet must write." *Id.* at 46.

66. *Id.* at 98.

67. Educational institutions, for example, provide instruction that improves or develops a person's capabilities, Treas. Reg. § 1.501(c)(3)-1(d)(3)(i)(a) (2002), thereby advancing one's "self-actualization."

68. BOGERT'S, *supra* note 29, § 379 & n.4. *See, e.g.*, Shenandoah Valley Nat'l Bank v. Taylor, 63 S.E.2d 786 (Va. 1951) (trust to pay a monetary sum directly to elementary school children each year at Easter and Christmas time neither advanced education nor relieved poverty and was not charitable); *In re* Gwyon, 99 L.J. Ch. 104 (1930) (trust to provide knickers for all boys between the ages of ten and fifteen in a particular district, regardless of financial need); *In re* Pleasants, 39 T.L.R. 675 (1923) (trust to provide a pennyworth of sweets for all boys and girls under the age of fourteen within a certain parish was not charitable).

69. SCOTT, *supra* note 18, § 398.1.

70. RESTATEMENT (SECOND) OF TRUSTS § 374 cmt. f (1957).

Under the common law, naked and indiscriminate altruism does not warrant the special advantages that accrue to charitable trusts.

The Internal Revenue Code ("IRC" or the "Code") draws upon the common law definition of "charitable" without necessarily adopting it wholesale.[71] The Code provides special tax advantages to organizations that are organized and operated primarily for one or more of eight purposes enumerated in IRC 501(c)(3).[72] This list is familiar and includes "religious, charitable, scientific, . . . literary, or educational purposes."[73] Section 501(c)(3) of the Internal Revenue Code exempts qualifying entities from paying corporate income tax on their net earnings (including interest earned on cash donations), and section 170 lets these entities' donors deduct contributions from their income taxes.[74]

2. *Organized to Benefit a Charitable Class.*—A charitable trust not only advances a legally charitable purpose, it does so for the benefit of the public-at-large or a sufficiently important section of the public, a.k.a. a "charitable class."[75] A trust that seeks to relieve poverty or promote education is not charitable if it also "serv[es] what amount to private trust purposes."[76] This occurs, for example, when the persons whose poverty is relieved or education promoted are pre-selected persons or the settlor's friends, family members or descendents.[77]

Although charitable trusts typically benefit an indefinite, open-ended class of persons (e.g., the victims of boating disasters), this is not required. They can sometimes benefit a definite or closed group of persons.[78] A particularly close question is presented by trusts to relieve the poverty or distress of a group whose members are known and fixed from the beginning and will not change. This is typically true, most notably, of trusts to aid the victims of a particular flood, fire, or tornado (e.g., the victims of "the burning of the excursion steamer *General*

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71. Galston, *supra* note 50, at 297-99.

72. IRC § 501(c)(3) (2000); I.R.C. § 501(c)(3) imposes two other requirements, not relevant here: "No substantial part" of the organization's activities may consist of "carrying on propaganda, or otherwise attempting, to influence legislation," and the organization must "not participate in, or intervene in . . . any political campaign on behalf of (or in opposition to) any candidate for public office."

73. *Id.*

74. *Id.*; I.R.C. § 170 (2000). There is no deduction for gifts to entities organized and operated for the purpose of testing for public safety, an exempt activity under I.R.C. § 501(c)(3).

75. CAIRNS, *supra* note 56, at 20.

76. RESTATEMENT (THIRD) OF TRUSTS § 28 cmt. a (Tentative Draft No. 2, 1999).

77. *Id.* § 28 cmt. f.

78. RESTATEMENT (SECOND) OF TRUSTS § 375 (1957); BOGERT'S, *supra* note 29, § 363; *cf.* Jackson v. Phillips, 96 Mass. 539, 556 (1867) ("A charity, in a legal sense, may be more fully defined as a gift . . . for the benefit of an *indefinite* number of persons . . . .") (emphasis added) (Gray, J., future Associate Justice of the U.S. Supreme Court). Judge Gray's statement regarding the indefinite nature of the beneficiary class was not essential to that case, which turned on whether the proposed trust's purposes were legally charitable.

Slocum, on June 15, 1904").[79] As Bogert, a leading treatise on trusts, has observed, "the persons who suffered physical injury or lost property as a result of this [particular disaster] are likely to be easily discoverable. In a relatively short time the trustees of the fund can ascertain the names and addresses of all the members of the class."[80] Under black letter law, the *charitableness* of such a trust turns on whether its beneficiaries are sufficiently numerous "so that the community is interested in the enforcement of the trust."[81] There is no bright-line rule as to how many beneficiaries it takes to turn a private class into a charitable one; it is a "question of degree,"[82] and "a matter of judgment as to the existence or nonexistence of a public, community or social interest."[83] Bogert concludes inconclusively that

> each court should decide for itself whether the size of the class to be aided is such that there is a general public interest in the execution of the trust, or whether the relief is so limited in amount as to make it solely a matter of the interest of the individual sufferers.[84]

The IRS is similarly vague as to how many persons a disaster must devastate before the victims comprise a charitable class for federal tax purposes.[85] The easy cases lie at the extremes. The IRS would deny 501(c)(3) exemption to an entity created to assist "a few persons injured in a particular fire."[86] By contrast, the residents of 100,000 homes damaged or destroyed in a hurricane are a charitable class, even if one could name every intended beneficiary at the outset.[87]

3. Entity Cannot Provide Excessive Private Benefits.—In addition to aiding a sufficient number of persons, a charity cannot provide too much aid relative to the charitable goals that it ostensibly advances. Stated differently, a charity must

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79. *See, e.g.*, Loch v. Mayer, 100 N.Y.S. 837, 838 (Sup. Ct. 1906).

80. BOGERT'S, *supra* note 29, § 363, at n.23.

81. RESTATEMENT (SECOND) OF TRUSTS § 375 (1957).

82. *Id.* cmt. a.

83. BOGERT'S, *supra* note 29, § 363 at n.22.

84. *Id.*

85. Ruth Rivera Huetter & Marvin Freidlander, *Disaster Relief and Emergency Hardship Programs*, *in* EXEMPT ORG. CONTINUING PROF'L EDUC. TECHNICAL INSTRUCTION PROGRAM FOR FY 1999 219, 226 (1999) ("organizations formed for assisting victims of disasters where a significant portion of the community is affected, are less susceptible to being formed for the benefit of a limited class, even though the number of potential beneficiaries may be fixed."). The IRS published this article in the annual Continuing Professional Education (CPE) course book that it provides to its agents, which is publicly available and well known to tax practitioners as a source of guidance.

86. *IRS, Disaster Relief: Providing Assistance Through Charitable Organizations* (advanced text of a special IRS publication), Sept. 17, 2001 [hereinafter *Disaster Relief* (advanced text)], *reprinted in* 34 EXEMPT ORG. TAX REV. 98, 99 (Oct. 2001).

87. *Id.* at 100.

actually operate to "serve[] a public interest rather than a private interest."[88] This means at a minimum that the organization's insiders—its founders, managers, members, or others in a position to control it—do not unduly benefit from its income and assets.[89] This is known variously as the bar against "private inurement"[90] or the "nondistribution constraint."[91] More broadly, an exempt organization cannot provide excessive benefits to *any* private entity or individual, including organizational outsiders.[92] This is known as the "private benefit" doctrine.[93]

Judge Richard Posner contrasts the concepts of private inurement and private benefit in *United Cancer Council, Inc. v. Commissioner*.[94] That case appealed the United States Tax Court's ruling that net earnings of the United Cancer Council, Inc. ("UCC"), a self-described nonprofit organization, had inured to the benefit of an insider. This ruling was unusual because the alleged insider was not a UCC director, officer, founder, or other fiduciary, but a for-profit firm that the UCC had hired to provide fundraising services. The arrangement was amiss, the IRS claimed, because the firm kept 92% of what it raised on the UCC's behalf. The IRS argued that this contract was so one-sided that "the charity must be deemed to have surrendered the control of its operations and earnings to the [firm]."[95] The Seventh Circuit sensibly rejected the private inurement claim on grounds that the contract between the UCC and the fundraiser had been negotiated at arm's length, such that the firm was not an insider. It remanded the case for a decision on whether the UCC was operated for the fundraiser's private benefit.

Judge Posner connects the private benefit bar to the duty of care, which requires charitable fiduciaries to take steps to prevent their organization's assets from being dissipated.[96] The prohibition against private inurement, by contrast,

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88. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 1990).

89. BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 428 (7th ed. 1998).

90. I.R.C. § 501(c)(3) (2002) ("no part of the [exempt organization's] net earnings . . . inures to the benefit of any private shareholder"); United Cancer Council, Inc. v. Comm'r, 165 F.3d 1173, 1174 (7th Cir. 1999) (interpreting "any private shareholder or individual" to mean an insider of the charity).

91. Henry B. Hansmann, *The Role of Non-Profit Enterprise*, 89 YALE L.J. 835, 838 (1980). Hansmann identifies this as the essential characteristic of nonprofit organizations.

92. *See* HOPKINS, *supra* note 89, at 460-62; Treas. Reg. § 1.501(c)(3)-1(c)(2) (as amended in 1990) ("An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders *or individuals*.") (emphasis added).

93. *See, e.g.*, Am. Campaign Acad. v. Comm'r, 92 T.C. 1053 (1989) (a school that trained individuals for careers as political campaign professionals was not charitable, even though it advanced education, because it substantially benefited the private interests of the Republican Party, where nearly all of the school's graduates served Republican entities or candidates).

94. 165 F.3d 1173 (7th Cir. 1999).

95. *Id.* at 1175.

96. *Id.* at 1180.

inheres in the duty of loyalty, which prohibits fiduciaries from looting the organization's resources for their personal gain. The private benefit bar offers a "route for using tax law to deal with the problem of improvident or extravagant expenditures by a charitable organization that do not, however, inure to the benefit of insiders."[97] It might apply, Judge Posner opined, if the "UCC was so irresponsibly managed that it paid [the firm] twice as much for fundraising services as [the latter] would have been happy to accept for those services."[98] In that case, 50% of the firm's fee would be "the equivalent of a gift."[99] "Then it could be argued," Judge Posner concluded, "that UCC was in fact being operated to a significant degree for the private benefit of [the fundraiser]."[100]

The private benefit doctrine need not be limited to contracts for consideration between a charity and an input supplier, as in *United Cancer Council.* It can also apply when an entity distributes extravagant aid (or "outputs") to beneficiaries, as suggested by *Ashton's Charity.*[101] This 1859 English case involved a testamentary trust to pay a rotating group of six almswomen an annual sum of £6 each, plus an equal share of the profits produced by certain property. A settlor who died in 1728 created the trust. After 130-odd years, some of its property was sold for £6000.[102] The court was asked how to dispose of the £6000: must it be distributed to the almswomen, as the trust's terms appeared to require? "I apprehend," the judge answered, "that the additions to the increase of almswomen *must have some limit.* [I]f this money were divided amongst the almswomen, they would thereupon cease to be almswomen," and become "persons from a higher rank . . . receiving a considerable income."[103] The court nominally located this limit in the settlor's intent: turning almswomen into wealthy gentlewomen "would not have the effect intended by the testatrix, but would destroy her object."[104] This assessment of the settlor's intent may or may not be accurate. Why, for example, would bestowing great wealth upon a half-dozen indigents necessarily *destroy* the settlor's intent which, after all, entailed improving their financial condition? It is more certain, by contrast, that the proposed payouts to the almswomen were extravagantly excessive relative to the charitable purpose they ostensibly advanced.[105]

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97. *Id.* at 1179 (dictum).
98. *Id.*
99. *Id.*
100. *Id.*
101. Re Ashton's Charity, 27 Beav. 115.
102. *Id.*
103. *Id.* at 118, 119 (emphasis added).
104. *Id.* at 119.
105. Using the English doctrine of prerogative cy pres, the judge directed that the £6000 be used for a Church of England school. *Id.* at 120. *See also* RESTATEMENT (SECOND) OF TRUSTS § 399 cmt. h (1957). Although this seems quite distant from the settlor's apparent intent, it was at least legally charitable—unlike the alternative of distributing the £6000 to the six almswomen.

C. Disaster Relief as a Charitable Activity

Disaster relief is a charitable activity because it aims to alleviate human suffering.[106] The harder questions involve the legal parameters for providing such relief under charitable auspices. More specifically: (1) Who are the appropriate recipients of such aid, and what are the appropriate criteria for allocating aid among them?; (2) At what point must a charity stop helping the victims of a particular disaster, either individual or collectively?; (3) When does disaster relief become a private benefit?; (4) If a disaster relief organization raises too much money, what happens to the surplus funds?

1. The Disaster Relief Organization.—The archetypal disaster relief fund or organization ("DRO")[107] is a nonprofit corporation under state law and tax exempt under I.R.C. § 501(c)(3).[108] It is eligible to receive tax-deductible contributions under I.R.C. § 170 and funds its activities primarily through donations.[109] It is governed by a board of directors that selects its own successors.[110] This formal independence is important because the law calls upon directors to resist demands by donors, beneficiaries, and others to act in legally noncharitable ways.

Within the universe of DROs, the most important distinction for our purposes is between general and disaster-specific charities. The general DRO serves an indefinite or open class of individuals, which consists of current and future victims of certain types of recurring disasters. It envisions waves of disaster victims in succession over time, and its spending pattern reflects this time

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106. RESTATEMENT (SECOND) OF TRUSTS § 375 cmt. I (1957); BOGERT'S, *supra* note 29, § 379; SCOTT, *supra* note 18, § 375.2 & n.43; SHERIDAN, *supra* note 18, at 164; Huetter & Friedlander, *supra* note 85, at 220 ("Generally, disaster relief organizations are exempt under IRC 501(c)(3) as organizations formed for the relief of the distressed"); Catherine E. Livingston, *Disaster Relief Activities of Charitable Organizations*, 35 EXEMPT ORG. TAX REV. 153, 153 (Feb. 2002) (citing Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended 1990)).

107. A DRO can be organized as a freestanding organization or as a separate disaster relief fund within an organization that serves broader purposes. For convenience, I will refer to both as "DROs."

108. The entity could also be incorporated under federal law, or structured as a charitable trust or unincorporated association under state law.

109. These donations can be analogized to third-party beneficiary contracts between the donors and the DRO. The person who contributes to the American Red Cross, writes Professor Hansmann:

> is in effect buying disaster relief. And the Red Cross is, in a sense, in the business of producing and selling that disaster relief. The transaction differs from an ordinary sale of goods or services, in essence, only in that the individual who purchases the goods and services involved is different from the individuals to whom they are delivered.

Henry B. Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 61 (1981) (footnotes omitted).

110. Hansmann refers to such nonprofits as "entrepreneurial," and contrasts them with "mutual" nonprofits governed by directors selected by the donors, members, purchasers of goods and services, and/or beneficiaries. Hansmann, *supra* note 91, at 841.

horizon. If the general DRO has an endowment, it may elect to use only the income to pay for its current relief operations. If supported through contributions, it will try to raise more money than what is needed to pay for current relief operations in order to have cash on hand to cover future operations without delay.[111] By contrast, a disaster-specific (or single-disaster) DRO exists to help the victims of a particular disaster. It typically spends all its assets soon after of the disaster to which the organization responded.[112]

Disaster-specific DROs vary in how precisely they define their class of potential beneficiaries. At one end of this spectrum is the charity that defines its mandate so broadly or with so much discretion that no one can claim an entitlement to assistance. Consider the charity formed to benefit "victims" of 9/11—a class that could potentially include anyone who experienced any economic or emotional distress as a result of the attacks. At the other end of the spectrum is the charity created to benefit the surviving spouses and children of those killed on 9/11 and only them. The more precisely a charity defines its intended beneficiaries, the more it looks like a private trust, whose beneficiaries can sue the trustees for fiduciary breach. The child of a 9/11 fatality, for example, has a "special interest" in a 9/11 survivors' fund's operations, and thus standing to maintain suit.[113]

2. Targeting Relief to the Needy and/or Distressed.—The DRO's target audience is disaster victims who lack the basic necessities as a result of the disaster's ravages. DROs typically do not provide superior or per se charitable goods such as education, religion, and culture. Rather, they deliver more prosaic goods and services designed to meet the basic physiological and security needs of people whom a disaster has rendered needy. DROs can provide victims with either the necessities themselves (in-kind aid) or the financial wherewithal to obtain them. More specifically, IRS officials advise, DROs "may provide loans or grants in the form of funds, services, or goods to ensure that victims of a disaster have the basic necessities such as food, clothing, housing (including household repairs), transportation, and medical assistance (including psychological help)."[114]

To qualify as charitable, DROs must meet both procedural and substantive

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111. *See* Hansmann, *supra* note 109, at 72-75 (nonprofit organizations have more difficulty raising capital than for-profits because of their inability to issue equitable ownership shares; as a result, they must rely more heavily on accumulated net earnings in order to finance expansion of their operations in response to increased demand).

112. As of October 31, 2002, the New York Firefighters 9-11 Disaster Relief Fund had distributed over 99% of the $161 million it collected. U.S. GAO, *September 11 Report*, *supra* note 2, at 31-32. The American Red Cross' Liberty Fund planned to disburse 90% of the almost $1 billion it raised by the first anniversary of the attacks. Stephanie Strom, *Families Fret as Charities Hold a Billion Dollars in 9/11 Aid*, N.Y. TIMES, June 23, 2002, at A29. The Twin Towers Fund intends to close by the end of 2003. Telephone Interview with Carolyn C. Cavicchio, Deputy Director, Twin Towers Fund (July 9, 2002).

113. *See supra* notes 31-34 and accompanying text.

114. Huetter & Friedlander, *supra* note 85, at 219.

criteria: They must have in place some means for assessing the neediness of aid applicants; and the aid provided must rationally relate in kind and quantity to the needs it allegedly addresses. "The type of aid that is appropriate to relieve distress in a particular case depends on the individual's needs and resources."[115] As federal regulators note elsewhere, "[A] person whose temporary need arises from a natural disaster may need temporary shelter and food but not recreational facilities."[116] Additionally, "[t]he ideal amount of aid is that which is necessary and sufficient to restore victims to a level where they can be productive, self-sufficient members of the community."[117]

In helping victims, a DRO can generally dispense in-kind assistance more liberally and with less means-testing than cash payments. There are many reasons why a disaster victim with a comfortable net worth might warrant a DRO's in-kind assistance, especially in the midst of a disaster and its immediate aftermath. In dire circumstances, a person's financial condition may be "useless in the absence of opportunity to purchase the needed supplies."[118] A DRO can thus rescue both Gilligan and Thurston Howell, III, for example, from a sinking S.S. Minnow without inquiring into their ability to pay.[119] Once on land, the DRO can continue to provide certain in-kind services to both regardless of their financial resources. The most common example of this is counseling in its many varieties:

> Evidence of financial need is not necessary when providing nonmonetary assistance such as counseling and other supportive services to individuals in distress. For example . . . providing individual and group counseling to widows to assist them in legal, financial, and emotional problems caused by [the] death[s] of their husbands qualifies as charitable.[120]

People require a certain amount of mental and emotional well-being in order to

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115. *Id.*

116. Treas. Reg. § 1.170A-4A(b)(2)(ii)(E) (2002).

117. Huetter & Friedlander, *supra* note 85, at 219.

118. ZOLLMAN, *supra* note 54, at 135-36 (citing Kronshage v. Varrell, 97 N.W. 928 (Wis. 1904)).

119. *See* Bjorklund, *supra* note 9, at 16; *Disaster Relief* (advanced text), *supra* note 86, at 100 (a person "requiring [rescue] services is distressed irrespective of the individual's financial condition.").

120. Huetter & Friedlander, *supra* note 85, at 227 (citing Rev. Rul. 78-99, 1978-1 C.B. 152) In Rev. Rul. 78-99, the IRS affirmed the 501(c)(3) exempt status of an entity that provided free counseling to widows to help them deal with the loss of a spouse and to inform them about available benefits and services, on grounds that it was operated for educational purposes. There seems no reason why the Service could not have affirmed the exemption on grounds that the entity's services helped relieve distress due to personal tragedy. *See, e.g.*, Treas. Reg. § 1.170A-4A(b)(2)(ii)(D) (2002) (defining a "needy person" as someone who lacks "the necessities of life, involving physical, *mental, or emotional well-being*, as a result of . . . temporary distress") (emphasis added).

be productive, self-sufficient members of the community. Mental and emotional counseling are especially appropriate after major disasters, which can cause those involved to suffer trauma and distress. Back on shore, both Thurston Howell and Gilligan can receive free mental health counseling to help them cope with their ordeal.[121]

As the calamity recedes, a DRO must increasingly differentiate among disaster victims based on their financial condition—especially with respect to financial assistance. Once victims have the opportunity to purchase the needed supplies, those in decent financial shape can satisfy their basic needs on their own. Once Thurston Howell can access his assets, he ceases to be an appropriate recipient of a charity's financial assistance. Even before that moment, he is a better candidate for a loan than an outright gift, as he suffers from a cash-flow problem rather than overall financial distress. The same might be true for Gilligan: Even if his bank account is currently empty, he may have adequate shipwreck insurance. In that case, a loan can tide him over until the insurance company sends a check.[122]

Critically, a DRO cannot make cash payments to people merely because of their involvement in a disaster, nor can it transfer funds to someone "without regard to meeting the individual's particular distress or financial needs"; such transfers, in the IRS's view, would constitute excessive private benefit.[123]

The IRS directs DROs to employ a three-step process before distributing aid to applicants.[124] First, the agency must have in place a needy or distressed test—a set of criteria by which it can objectively make distributions to individuals who are financially or otherwise distressed.[125] Second, the DRO must determine that an applicant meets its "needy or distressed" test before dispensing aid, that is, it "must make a specific assessment that a recipient of aid is financially or otherwise in need."[126] Third, the agency must generally keep adequate records and case histories to support the basis upon which assistance is provided.[127]

The formality and thoroughness of the requisite inquiry varies with the

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121. *See* Bjorklund, *supra* note 9, at 16.

122. Huetter & Friedlander, *supra* note 85, at 227 ("An organization may elect to extend loans to persons covered by insurance, with the requirement that the recipient repay the loan when the insurance proceeds are received provided insurance is sufficiently adequate so that repayment of the loan does not cause further personal hardship").

123. *Id.*

124. This is the IRS's gloss on the law. Although "relief of the poor and distressed" is a charitable purpose under federal tax law, neither the Code nor its implementing regulations expressly require charities to verify an aid applicant's poverty or distress before dispensing assistance. Livingston, *supra* note 106, at 154.

125. *Disaster Relief* (advanced text), *supra* note 86, at 100.

126. *Id.*; IRS, *Disaster Relief: Providing Assistance Through Charitable Organizations* (final text) 7, *available at* http://www.irs.gov/pub/irs_pdf/p3833. pdf (last visited Mar. 4, 2003) [hereinafter *Disaster Relief* (final text)].

127. *Disaster Relief* (advanced text), *supra* note 86, at 9-10; *see also* Rev. Rul. 56-304.

circumstances. Generally speaking, a DRO can be more lax in distributing short-term aid in the midst of a disaster or immediately thereafter—especially for non-monetary forms of assistance. During the immediate stages of a relief effort—typically the first forty-eight hours[128]—"only a minimum of information would generally be required to be collected from recipients," such as "a brief description of loss suffered, and the type and amount of assistance needed . . . ."[129]

"After immediate critical needs have been satisfied," however, "complete and appropriate documentation for providing aid to satisfy long term needs must be maintained to demonstrate the charitable nature of the relief"[130]—especially for cash payments or subsidies. The IRS advises DROs to undertake a full-blown financial needs assessment before, for example, providing a family with enough funds to pay for three to six months of housing.[131] The requisite inquiry into the applicant's financial condition may be quite extensive, and some may find it intrusive. Long-term financial aid awards, IRS officials have advised:

> [S]hould be made on findings of financial hardship based on a determination that the potential recipient's available cash, assets that can be disposed of without causing further personal hardship, and anticipated cash flow (income, insurance proceeds, etc.) from all sources can reasonably be expected to be insufficient to provide for timely retirement of existing obligations and basic needs.[132]

3. Disaster Relief and Tort Compensation Compared.—One can better appreciate charitable disaster relief by comparing it to compensatory damages in tort. Any alteration in the status quo that injures people or their property may be an appropriate occasion for DROs' volunteer payments and for the tort system to require them. One key difference lies in the baseline or yardstick each scheme uses to determine the appropriate amount. The tort system permits an injured person to obtain a monetary award for the *entire* loss in value she has suffered as a proximate cause of another person's breach of a legal duty. Charity law, by contrast, contemplates smaller awards but in a wider set of circumstances. Its

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128. *See, e.g.*, LONDON BOROUGH OF CROYDON, SOCIAL SERVICES DEPARTMENT, CARING RESPONSE PLAN 7 (Oct. 2001) (defining the first forty-eight hours after a disaster as the "immediate response" stage and the most critical), *available at* http://www.croydon.gov.uk/csdept/security/Caring_Response_Plan.doc (last visited Feb. 9, 2003).

129. Huetter & Friedlander, *supra* note 85, at 228.

> In most cases, records containing basic information such as names, addresses, telephone numbers, social security numbers, a brief description of loss suffered, and the type and amount of assistance needed and granted should be maintained. However, in some emergency circumstances, it may be sufficient merely to provide assistance to the distressed without even obtaining this minimal information provided there is some recordation concerning the uses to which the funds were put.

130. *Id.*

131. *Disaster Relief* (final text), *supra* note 126, at 7.

132. Heutter & Friedlander, *supra* note 85, at 227.

relief is narrower because it authorizes DROs to respond to loss only insofar as it leaves people without basic necessities or the wherewithal to obtain these. It is broader because it authorizes assistance whenever people experience hardship, regardless of fault. This includes cases where no party was obliged to prevent the hardship, where the liable party does not compensate the victim fast enough to stanch the suffering, or where the victims caused their own misfortune.

Compensatory damages in tort law aim to fully indemnify the victim of a legal wrong.[133] The damage award should approximate the difference between victim's well-being in the pre- and post-tort world, insofar as this loss can be: (1) measured in money (e.g., lost earnings, bodily injury, pain and suffering); and (2) attributed to the tortfeasor. She can obtain compensation regardless of the magnitude of the loss and whether it has left her distressed.

By contrast, DROs cannot make payments to people simply because a disaster has caused them some harm. Consider the person whose uninsured, unoccupied vacation home has been destroyed by a hurricane. Although he has incurred a loss, "it does not follow that the person is therefore distressed and needy."[134] A person whose primary residence has been destroyed is a stronger candidate for assistance, especially during the hurricane and immediately afterwards. Even here, however, there are limits to how much aid, if any, a charity can provide. A DRO, the IRS advises, "does not have to make an individual whole, such as by rebuilding the individual's uninsured home destroyed by a flood, or replacing an individual's income after the person becomes unemployed as the result of a civil disturbance."[135] More pointedly, a DRO *cannot* restore a victim to the pre-disaster world where doing so provides him with more than what is required to relieve his distress and meet his basic needs: disaster relief is not insurance.[136]

> For example, rebuilding an individual's luxury estate would serve a private rather than a public interest where meeting the individual's basic needs may be limited solely to providing temporary housing. Similarly, grants to replace lost income rather than to meet basic living needs would generally be viewed as serving personal and private interest.[137]

The difference between tort law and charity law can also be seen in how each treats payments the victim receives from other sources for the same harm. Under tort law, if a victim receives compensation for the tortfeasor-inflicted harm from another source (e.g., governmental benefits, first-party insurance, private charity, etc.), such payments cannot be deducted from the damages that he can otherwise collect from the tortfeasor.[138] This principle, known as the "collateral source

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133. *See, e.g.*, Portee v. Hastava, 853 F. Supp 597, 618 (E.D.N.Y. 1994).
134. Huetter & Friedlander, *supra* note 85, at 227.
135. *Disaster Relief* (final text), *supra* note 126, at 8.
136. Kronshage v. Varrell, 97 N.W. 928, 930 (Wis. 1904).
137. Huetter & Friedlander, *supra* note 85, at 227.
138. BLACK'S LAW DICTIONARY, *supra* note 53, at 256-57 (defining "collateral source rule").

rule," sometimes permits the victim to be made whole several times.[139] Unlike the tort system, DROs generally should consider the help a disaster victim receives from other sources.[140] If it were to ignore collateral sources, the charity would favor victims better able to help themselves to the detriment of those who need more help. This is perverse and contrary to a DRO's mission.

D. How Charity Law Disposes of Surplus Disaster Relief Funds

"You can never be too rich or too thin," says the wag. As a financial matter, this maxim is true for many general DROs: they can generally expect future instances of the type of disasters they were created to relieve. A short-term plethora of unrestricted or redeployable gifts can almost always be put to good use, sooner or later. Disaster-specific DROs, by contrast, respond to one-time events that affect a finite number of persons and whose effects diminish over time. It is thus possible for them to raise more money than required to ensure that all the victims of a particular event have or can obtain the basic necessities. General DROs can face a similar problem when they receive too many gifts restricted to a particular disaster. These possibilities raise a number of questions: What constitutes a surplus, what is to be done about it, and who decides?

1. What Happens to the Surplus?—If the gift's terms do not address the issue of surplus, the law must provide a default rule. There are at least three ways to dispose of these excess funds, apart from simply refunding the balance to the donors. In theory, the law attempts to discern what the donor actually wanted or would likely have wanted to happen. In practice, the law tends to impute to the donor certain preferred accounts of her intentions.

a. Three possibilities.—If a charity achieves a donor's aims without consuming her entire gift, then the surplus presumptively reverts to the donor or those claiming under her (i.e., her heirs or devisees) via a resulting trust[141]—that is, unless a court determines that the donor "properly manifested an intention" that no such trust should arise.[142] More specifically, no resulting trust arises if the donor indicated that the surplus should be: (1) redirected to a different but closely related charitable purpose, but one not necessarily pursued by the same

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139. This outcome can be justified on grounds that, inter alia, an alternate rule would reduce the potential tortfeasor's incentives to take care, thereby increasing the future incidence of injury.

140. This is the Red Cross' official policy. *See* American Red Cross, "Plan for Application of Remaining Designated Funds, 1997 DR-344 and DR-345, Minnesota and Red River Valley Floods" 1 (June 5, 1998) (on file with author) ("Red Cross relief is provided to sustain human life, reduce the harsh physical and emotional distress that prevents victims from meeting their own basic needs, and promote the recovery of victims *when such relief is not available from other sources.*") (emphasis added).

141. *See* Annotation, *Rights and Remedies in Respect of Claimed Surplus Over the Amount Necessary to Carry Out the Expressed Purpose of a Charitable Trust*, 157 A.L.R. 903, 906 § II.b (1945).

142. RESTATEMENT (SECOND) OF TRUSTS § 432 (1957).

donee;[143] (2) used by the same charity (presumably a multi-purpose entity) for a different corporate purpose, but one not necessarily related to the settlor's designated purpose (other than the fact that the same organization pursues both); or (3) used to enrich the donor's intended beneficiaries in a benevolent but legally non-charitable manner.[144]

(i) Use surplus for a related charitable purpose: the cy pres doctrine.— When a donor creates a charitable trust for a single charitable project, the common law traditionally presumed that she intended to aid that specific project "and nothing else."[145] If that aim was achieved without exhausting the gift's assets, the court presumed that the donor wanted or would have wanted the balance refunded.[146] This presumption was overcome if the settlor was found to have manifested a "general charitable intention."[147] Even though such a donor seeks to advance a particular object, her "paramount or overriding intention" is to advance "the charitable purpose of which the particular object set out . . . is merely one mode of furtherance."[148] The donor's purpose was simply one means to a larger charitable end, or one species in a genus of charitable purposes. In redirecting the surplus, a court selects a goal as near as possible to the donor's original one. This approach is reflected in the name of this doctrine or equitable power—cy pres, from the Norman French term "*cy pres comme possible*," or "as near as possible." The donor, it is thought, would have preferred this result (had she considered the matter) to the alternative—refunding the gift to herself or her successors in interest.[149]

The modern approach to cy pres presumes, in principle or in practice, that the donor had "a general charitable intention" unless she expresses otherwise.[150] This approach is grounded firmly in policy: Where the evidence regarding the donor's intent is equivocal, speculative or non-existent, charity law favors an interpretation that keeps the gift's assets flowing in charitable channels, where

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143. *Id.*; *see id.* § 432 & cmt. a (applying cy pres doctrine to the case of surplus in a charitable trust).

144. *See id.* § 432 cmt. b.

145. BOGERT'S, *supra* note 29, § 436.

146. *See, e.g.*, Holmes v. Welch, 49 N.E.2d 461, 463 (Mass. 1943).

> In the present case the testator gave no indication that his bounty was not to be limited to the purposes provided for by the will. No intent appears to have any part of the trust fund devoted to any other charitable purpose. Under these circumstances the cy pres doctrine does not apply, and any surplus must be held on a resulting trust for the heirs or next of kin of the testator.

147. RESTATEMENT (SECOND) OF TRUSTS § 399 (1957).

148. WATERS, *supra* note 56, at 624.

149. *See* Howard Sav. Inst. v. Peep, 170 A.2d 39, 43 (N.J. 1961) (asking whether the donor had a general versus specific charitable intent is "just another way of asking 'would [the donor] have wanted the trust funds devoted to a like charitable purpose, or would he have wanted them withdrawn from charitable channels.'").

150. RESTATEMENT (THIRD) OF TRUSTS § 67 cmt. b (Tentative Draft No. 3, 2001); EDITH L. FISCH ET AL., CHARITIES AND CHARITABLE FOUNDATIONS § 575 (1974).

they will presumably generate more public benefit than if returned.

(ii) Let the same charity retain the surplus for another corporate purpose.—When a donor gives to a single-purpose charitable trust, any surplus, generally speaking, must either be returned to the donor or her successors or be redeployed to a closely related purpose via cy pres. When the donee is a multi-purpose charitable corporation, by contrast, there is sometimes another option: the corporation may be permitted to use the surplus for other corporate purposes, i.e., treat it as an unrestricted gift.[151] This differs somewhat from a classic cy pres approach in which the donor is deemed to have embraced a larger general charitable purpose and merely specified a particular means of advancing it. Here the donor is deemed to have embraced a certain organization and merely designated a specific project it pursued. In the first instance, the charity must apply the gift to the specific project designated by the donor. If the charity completes this project with spare funds, however, then courts may assume that the donor wanted (or would have wanted) the same organization to be able to use the surplus for other organizational purposes.[152]

(iii) Use surplus to enrich the same beneficiaries.—A third way to distribute a charitable trust's surplus is to transfer it to a private trust for non-charitable purposes. To achieve this result, the settlor must "properly manifest[] an intention that if there should be a surplus remaining after the performance of the charitable trust the trustee should hold the surplus . . . upon a valid private trust . . . ."[153] Here then is a two-step approach for settlors whose "paramount or overriding intention" is to create a fund the entirety of which will be used to benefit a definite group of disaster victims and *only* them. As a first step, these donors can fund a disaster-specific charitable trust that will terminate when all the victims' basic needs have been met. If and when that occurs, any surplus can then be "gifted over" to a private trust to benefit the same group of victims without regard to their financial need or distress. This private trust, for example, could simply give each victim or victim's estate an equal share of the balance. This approach permits at least some donations—the ones received and disbursed up until the point basic needs are fully met—to be distributed under charitable auspices. This arrangement permits the pre-surplus donors and donee charity to obtain favorable tax treatment.[154]

Something like a gift-over from charity to non-charity occurred in *Doyle v. Whalen*,[155] which involved funds raised after an 1886 fire that destroyed most of

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151. RESTATEMENT (SECOND) OF TRUSTS § 400 cmt. c (1957); *see also id.* § 431 cmt. e; Attorney-General v. Rector and Churchwardens of Trinity Church, 91 Mass. (9 Allen) 422 (1864).

152. *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 432 cmt. b (1957).

153. *Id.*

154. To be valid, such "gift overs" must be certain to occur within the period of the Rule Against Perpetuities. *Id.* § 401 cmt. g. Disaster-specific relief trusts invariably satisfy this requirement, as all their beneficiaries—the victims of a disaster that has already occurred—are alive (i.e., lives in being) when the trust is created.

155. 32 A. 1022 (Me. 1895). For background on this fire, see http://fis.com/eastport/visitors.html (last visited Sept. 23, 2002).

Eastport, Maine.[156] That catastrophe inspired spontaneous gifts exceeding $38,000 to benefit the victims. The donors' overarching intention, the court concluded, was to benefit the sufferers of this fire and no one else.[157] The monies were received by an informal group of town leaders, who believed that they were administering a charitable fund "for the relief of actual suffering and distress caused by the fire."[158] After spending only $3000, the trustees determined that they had fully accomplished the fund's purpose. In their own words, they "had relieved every instance of distress then existing in Eastport, according to their best knowledge and belief, which had resulted from said conflagration."[159] These trustees then began using the balance to assist other poor people in town (i.e., to "support paupers")—even if their plight was unrelated to the fire.[160] Some fire victims challenged the trustees' actions, and asked the court to appoint a receiver to distribute the alleged surplus to members of this class.

In its decision, the Maine Supreme Court chastised the trustees for failing to manage the fund "in the spirit of helpful beneficence and liberality contemplated by the charitable donors."[161] The donated sums need not be entirely or irretrievably imposed with a charitable trust, as the trustees thought. Once the victims' immediate distress was relieved, the court concluded, the donors likely would have wanted the surplus to be used to repair or indemnify the victims' uninsured losses. At that point, the balance would become "a private trust for the benefit of the sufferers by the fire."[162]

b. Divining a donor's wishes for disposing of surplus.—How does a court ascertain whether a charitable donor manifested an intention to disclaim any surplus in favor of one of the three alternatives discussed above? Consider the surplus in a trust created by a single settlor pursuant to a written instrument. The court first examines the language of this instrument as interpreted in light of all the circumstances.[163] It may also hear other evidence bearing on the donor's actual or probable preferences.[164] Even with a single settlor, however, the search

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156. *Doyle*, 32 A. at 1024.

157. *Id.* at 1026 (the donors' "bounty was distinctly limited to a specified class of persons then in being. As stated in some of the [donors'] letters, it was 'for the benefit of the sufferers by the fire.'").

158. *Id.* at 1025.

159. *Id.* at 1023.

160. *Id.*

161. *Id.* at 1026.

162. *Id.* at 1025. The court raised and rejected the possibility of returning the surplus after the gifts' charitable purposes had been achieved. Although "[t]his would have been the obvious equity of the situation," it was too impracticable to carry out given the small size of most of the donations and anonymity of many donors. *Id.* at 1025-26. It did not address the possibility of returning donations to those donors who *could* be identified, which suggests that it never seriously contemplated refunds.

163. RESTATEMENT (SECOND) OF TRUSTS § 412 cmt. a (1957); SCOTT, *supra* note 18, § 431.

164. *See, e.g.*, IND. CODE § 30-4-3-27 (1998) (codifying common law cy pres doctrine permits a settlor's heirs to "present evidence to the court of . . . the heir's . . . opinion of the settlor's

for intent is seldom simple. As one commentator has written, "the donor generally fails to foresee the possible failure of his particular purpose."[165] The intent sought is thus hypothetical and counterfactual: How would the donor have wanted the surplus distributed had she considered the question at all and under the current circumstances? In most cases, another commentator writes, a court will lack sufficient information about a testator's preferences "to construct an individualized model of how that person's desires and beliefs would change in the circumstances before the court."[166]

Divining an individual donor's intent becomes even harder for gifts received in response to a broad-based solicitation campaign. Such campaigns characteristically generate a large number of modest gifts relatively few of which may be accompanied by a written instrument.[167] Depending on the number of donors and the size of their gifts, ascertaining how each donor wanted or would have wanted any of the surplus distributed could cost more than the total amount raised. For anonymous donors,[168] it may simply be impossible to determine their preferences.[169] In light of these obstacles, courts look primarily to the terms contained in the charity's solicitation to the public,[170] which constitute each solicited gift's "instrument" in the main or its entirety.[171] They will examine, for example, the charity's solicitations "by advertisements, posters, announcements on television or radio, or even by the oral statements of collectors or sponsors."[172] These terms are critical, it has been explained, because "when donors entrust

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intent").

165. FISCH ET AL., *supra* note 150, § 575, at 439.

166. Vanessa Laird, Note, *Phantom Selves: The Search for a General Charitable Intent in the Application of the* Cy Pres *Doctrine*, 40 STAN. L. REV. 973, 999 (1988).

167. *See, e.g.*, Loch v. Mayer, 100 N.Y.S. 837, 840 (Sup. Ct. 1906) ("Few donations [to relief fund for victims of General Slocum disaster] were accompanied with writing of any kind, and no such writing . . . states with any attempt at precision the terms of the trust.").

168. This is a common occurrence. *See, e.g.*, *id.* at 838 ("a large part of [donations to fund to relieve victims of General Slocum disaster] came from donors unknown to the [trustees], whose identity cannot now be determined").

169. Donors who give anonymously would seem to convey a relative lack of interest in reclaiming a portion of any surplus.

170. *See, e.g.*, *In re* North Devon and West Somerset Relief Fund Trusts, [1953] 2 All E.R. 1032 (ascertaining donor intent by analyzing the terms of the appeal by which the subscriptions were invited); *In re* Gillingham Bus Disaster Fund [1957] Ch. 300.

171. *See, e.g.*, National Conference of Commissioners on Uniform State Laws, Uniform Management of Institutional Funds Act § 2(6) (definition of "gift instrument" includes "the terms of any institutional solicitations from which an institutional fund [i.e., a fund held by a charitable institution for its exclusive use, benefit, or purposes] resulted") (draft, Nov. 2002); *Loch*, 100 N.Y.S. at 842 (an instrument creating a charitable trust need not be in writing, but may consist of the body of language, expressions, or conduct that express the intent that originally created and defined the trust).

172. WARBURTON & MORRIS, *supra* note 18, at 633; Elizabeth Cairns, *Appeals and Fund Raising*, PRIV. CLIENT BUS. 1994, at 2, 126-32.

their gifts to the fundraisers [i.e., the charity's trustees], they assume the money will be used for the purpose stated in the appeal. The terms of the appeal are taken to represent the donors' intention in making the gifts."[173]

Restricted gifts to a multi-purpose charitable corporation entail another set of interpretive possibilities and complexities. If the corporation accomplishes the original purpose without exhausting the gift, the surplus might remain in the charitable stream in one of two ways: (a) a court could redeploy it to a substantively related purpose via cy pres, perhaps by transferring it to another charity; or (b) the corporation may treat the excess funds as unrestricted and use them for other corporate purposes. In this situation, common law courts appear more likely to conclude that the donor would have preferred the second option.[174] The fact that the settlor chose to give to charity, says the Second Restatement, suggests "that the settlor intended that if the trust should fail it should be empowered to use the property for its general purposes."[175] The donor who wants any surplus from a gift given for a specified purpose to be judicially redeployed via cy pres bears the burden of expressing this preference. This burden, moreover, is surprisingly high. According to the Second Restatement:

> If property is given to a charitable corporation *to be applied to one of the purposes* of the corporation, and the purpose is fully accomplished without exhausting the trust property, the court will direct the application of the surplus by the corporation to the other charitable purposes of the corporation, *unless the settlor manifested an intention to restrict his gift to the particular purpose* which he specified.[176]

To rebut the presumption of unrestricted redeployment, the donor to a charitable corporation who seeks a more traditional cy pres treatment must effectively restrict her gift *twice*. She must express a desire that: (a) the charity use her gift for the specified purpose in the first instance; and (b) any surplus be used for a

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173. Law Reform Commission Of British Columbia, *Report On Informal Public Appeal Funds*, at 4 (Jan. 1993), *available at* http://www.bcli.org/pages/publications/lrcreports/repsum129.html (last visited Sept. 7, 2002).

174. RESTATEMENT (SECOND) OF TRUSTS § 431 cmt. e (1957) ("If . . . the trustee is a charitable corporation it is easier to find a manifestation of intention that the trustee should keep the surplus for its general charitable purposes."); SCOTT, *supra* note 18, § 432 & N.3; Annotation, *Rights and Remedies in Respect of Claimed Surplus Over the Amount Necessary to Carry Out the Expressed Purpose of a Charitable Trust*, 157 A.L.R. 903, 909 (1945) ("The fact that the donee is itself a general charity may be a factor in showing an intention . . . to leave the surplus, or the shares of particular subscribers, in the hands of the donee for its general purposes, but such an intention is not be presumed.").

175. RESTATEMENT (SECOND) OF TRUSTS § 432 cmt. b (1957) (nature of donee organization "may although it does not necessarily indicate" this intention); *see also* RESTATEMENT (THIRD) OF TRUSTS § 8 cmt. f (Tentative Draft No. 1, 1996) ("Among the circumstances that may be of importance in determining the existence or nonexistence of an intention that the trustee may retain the property free of trust are . . . whether the trustee . . . is a charitable corporation.").

176. RESTATEMENT (SECOND) OF TRUSTS § 400 cmt. c (1957) (emphasis added).

purpose closely related to the one that she specified.

c. Federal tax law favors continued charitable use.—Under the common law, a charitable gift's surplus can be used either charitably (i.e., for a closely related charitable purpose via cy pres, or for the donee charity's general corporate purposes) or non-charitably (i.e., by refunding the balance to the donor or transferring it to a private trust for a definite group of beneficiaries). Federal tax law is not neutral on this point: it creates incentives for donors to permit any surplus to be used for another charitable purpose.

Under the Code, a donor generally cannot claim a charitable deduction for a contribution that consists of less than her entire interest in the donated property.[177] This occurs, most notably, when a donor conditions her gift on the right to reclaim any surplus that remains after the designated purpose has been accomplished: this is known as a "possibility of reverter."[178] Such a gift will be deductible, however, if the risk that the act or event triggering reversion is so remote as to be negligible.[179] Yet the risk that a disaster-specific DRO will raise too much, as history shows, is not so remote as to be negligible. For this reason, the donor who retains a reverter interest in the surplus of such gifts may not receive a charitable deduction.

This conclusion finds support in Revenue Ruling 72-194, which involved a group of taxpayers who helped finance a state-run steeplechase race to promote tourism. These sponsors agreed to advance funds that a state agency could use to pay off any debt that could not be paid out of the race's projected revenue. The agency in turn agreed to return any advanced funds it did not use. The IRS apparently concluded that there was a non-negligible possibility that the agency would be able to return some of the advanced funds. The IRS ruled that these sponsors could only deduct the sums not returned. Moreover, these sponsors could not deduct *any* portion of the advance "until such time as the net amount actually going to the State is definitely determined by a final accounting."[180]

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177. I.R.C. § 170(f)(3)(A) (2000).

178. *In re* Gillingham Bus Disaster Fund [1957] Ch. 300, 310 (J. Harmon) ("the settlor or donor did not part with his money absolutely out and out but only sub modo to the intent that his wishes as declared by the declaration of trust should be carried into effect. When, therefore, this has been done any surplus still belongs to him.").

179. I.R.C. §§ 1.170A-1(e), 1.170A-7(a)(3) (2000). The phrase "so remote as to be negligible" has been defined as "a chance which persons generally would disregard as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction," United States v. Dean, 224 F.2d 26, 29 (1st Cir. 1955), and "a chance which every dictate of reason would justify an intelligent person in disregarding as so highly improbable and remote as to be lacking in reason and substance." Briggs v. Comm'r, 72 T.C. 646, 657 (1979), *aff'd without published opinion*, 665 F.2d 1051 (9th Cir. 1981).

180. Additional support may be found in Revenue Ruling 79-249. In that case, a board of education solicited public contributions to help construct a school building. The board told donors that if contributions fell short of a certain amount—10% of the construction costs—then no building would be built and the contributions returned. (The board also said that it would retain any surplus for general school purposes.) The IRS denied donors a charitable deduction under

2. What Constitutes a Surplus, and Who Decides?—A charitable gift yields a surplus when the purposes for which it was formed have been accomplished without exhausting its assets.[181] But when is that exactly, especially in the disaster relief context? When does a distribution exceed what is necessary and sufficient to ensure that disaster victims can obtain the basic necessities? There are easy cases where the aid is extravagant, for example, if the Red Cross were to rebuild luxury vacation homes damaged by a hurricane. In most cases, however, the surplus question is open to wide interpretation and dispute.[182]

Because the surplus question can be so hard to resolve, it may be more fruitful to ask when and how the question arises, who is empowered to answer it, and what are the answer's parameters. The issue can present itself in a number of settings. First, a charity's managers may conclude that a surplus exists and seek judicial instructions or sanction for redeploying the balance via cy pres.[183] Second, the managers may conclude that a surplus exists and unilaterally begin using the funds for another purpose, but without prior judicial approval for their action. Technically, this is a breach of trust, but the action will not be disturbed unless a party with standing brings suit. Even if such a suit is brought, the end result may be the same, breach notwithstanding. Stated differently, a court can retroactively ratify the managers' redeployment, and "such approval will be as effective as though the court had authorized the application before it was made."[184] Lastly, the issue can arise when the donor or her successors ask a court to declare a surplus and impose a resulting trust upon it for their benefit.[185]

A DRO's managers decide in the first instance whether they have accomplished the charity's purpose without exhausting its assets. Under the "best judgment rule" (the nonprofit analogue to the "business judgment rule"), courts are obliged to defer to the managers' decision unless it is arbitrary, capricious, or made in bad faith.[186] I have found only one case in which a court

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I.R.C. § 170 on grounds that the possibility that contributions would be returned was not so remote as to be negligible. No deduction would be allowed unless and until the contributions were devoted to building or for general school purposes.

181. RESTATEMENT (SECOND) OF TRUSTS § 432 (1957).

182. The Restatement (Second) of Trusts states that "[w]hether or not the trust is fully performed depends upon the extent of the purposes of the trust, which is ordinarily a question of interpretation." RESTATEMENT (SECOND) OF TRUSTS § 430 cmt. g (1954).

183. *See, e.g.*, Loch v. Mayer, 100 N.Y.S. 837 (Sup. Ct. 1906). After spending approximately 27% of a $12,622.40 fund raised to assist the victims of a steamboat fire, the fund's trustees declared "that in no case has an applicant worthy of relief been denied assistance commensurate with his or her loss, where such loss could be relieved by money." *Id.* at 838. The trustees then sought judicial guidance on how to dispose of the remaining 73%. *Id.*

184. RESTATEMENT (SECOND) OF TRUSTS § 399 cmt. e (1959). If the court finds that the trustees breached the trust by declaring a surplus and/or redeploying its funds, then it can compel the trustees to perform the trust and to make restitution for their breach. *See id.* § 401 cmt. a.

185. *See, e.g.*, First Nat'l Bank of Kansas City v. Stevenson, 293 S.W.2d 362 (Mo. 1956) (heirs sought trust's income in excess of the prescribed distribution).

186. Holmes v. Welch, 49 N.E.2d 461, 465 (Mass. 1943) (sustaining demurrer because

ordered a DRO to spend more money on the victims, notwithstanding the directors' declaration of surplus.[187] A more representative case is *Boenhardt v. Loch*, which involved a fund for victims of the General Slocum, a steamboat that caught fire in New York City's East River in 1904, resulting in the deaths of over one thousand passengers.[188] The complaint alleged that the trustees had breached their fiduciary duties by failing to distribute all of the funds collected to victims' families. The court refused to second-guess the trustees' decision: "[i]f the funds [raised to relieve the victims of a particular disaster] may still be expended for such relief," the court declared, "it is the duty of the trustees, and not the province of this court, to act and to exercise discretion therein and thereto."[189]

Disaster-specific DROs also have some discretion *not* to declare a surplus, so long as the assistance provided with such funds does not result in private benefit. Even if all of the victims have adequate resources to meet their immediate basic financial needs, the charity can set aside funds to meet their possible future needs.[190] Determining whether to retain funds and how much to retain for such needs requires a judgment as to the financial future, and courts will generally not disturb that judgment.[191]

A DRO has the most latitude not to declare a surplus if, after meeting immediate and short-term needs, it spends the balance on in-kind assistance to victims. There seems to be almost no limit, for example, on how much it can spend on counseling to help those experiencing psychological and emotional distress attributed to the disaster.[192] Eight years after the Oklahoma City

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plaintiff failed to allege that trustees decided arbitrarily, capriciously, or in bad faith) (citation omitted); FISHMAN & SCHWARTZ, *supra* note 29, at 178-79.

187. Doyle v. Whalen, 32 A. 1022 (Me. 1895). In this case, the court removed the trustees of a disaster-specific DRO who had declared a surplus after spending only 8% of the $38,000 collected (or $3000). The majority found that the charitable surplus should be treated like a private trust for a definite group of victims. In a separate opinion, one judge concurred in the court's judgment because "[t]he proofs show that suffering entailed by the calamity still remains." *Id.* at 1027 (Haskell, J., concurring).

188. Boenhardt v. Loch, 107 N.Y.S. 786 (Sup. Ct. 1907). For more information on this disaster, see Bill Bleyer, *The General Slocum Disaster*, *at* http://www.lihistory.com/7/hs743a.htm (last visited Aug. 13, 2002); David Oats, *Disaster at Hell Gate*, QUEENS COURIER, *at* http://www.queenscourier.com/spclissue/slocum/slocum1.htm (last visited Aug. 13, 2002); and WILLIAM KORNBLUM, AT SEA IN THE CITY (Algonquin Books 2002), *excerpted at* http://www.newyorkhistory.info/Hell-Gate/General-Slocum.html (last visited Aug. 13, 2002).

189. *Boenhardt*, 107 N.Y.S. at 787. The court noted that there was no evidence of misfeasance or of malfeasance by the trustees. *Id.* The court decided the case without reaching the question of whether the disaster victim had standing to bring the suit. *Id.*

190. IRS, *IRS Releases Advanced Text of Publication on Disaster Relief*, 34 EXEMPT ORG. TAX REV. 98, 100 (2001).

191. *See, e.g.*, Holmes v. Welch, 49 N.E.2d 461, 465 (Mass. 1943).

192. Huetter & Friedlander, *supra* note 85, at 227 (citing Rev. Rul. 78-99, 1978-1 C.B. 152 (1978)). In Rev. Rul. 78-99, the IRS affirmed the 501(c)(3) exempt status of an entity that provided free counseling to widows to help them deal with the loss of a spouse and to inform them about

bombing, for example, contributions restricted to that calamity are being used to provide mental health services to some three dozen people.[193] Similarly, some of the largest 9/11-specific DROs plan to spend many millions of dollars to alleviate the grief, stress, and trauma caused by the attacks.[194] Yet such expenditures can become increasingly difficult to justify over time, and indeed some 9/11 donors are already questioning the scale of such expenditures.[195] The phenomenon of diminishing marginal utility suggests that each additional dollar spent on counseling a given victim brings less peace of mind than the previous dollar.[196] If it takes $1000 to meet a victim's basic physiological needs, for example, it might take another $2000 to meet her need for safety, $4000 to provide her with a sense of belonging, and so on up Maslow's hierarchy of needs. One might readily conclude that it misallocates society's disaster-relief resources to spend large sums of money ($16,000) to enhance one victim's self-esteem, instead of satisfying the most urgent physical needs of sixteen victims of another disaster.

3. Using Private Trusts to Distribute Surplus to Victims.—Once a disasters' victim's basic needs have been met, charity law prohibits DROs from distributing the balance to them.[197] Even so, there are at least two ways to transfer excess funds to the victims.[198] One option, discussed above, is for donors to expressly gift over any surplus to a private trust for the same group of victims. Another possibility is for public authorities to retroactively reclassify an oversubscribed charitable trust as private. This appears to have happened with funds raised for victims of the 1886 fire in Eastport, Maine,[199] and more recently with an English fund created in 1981. That case warrants closer inspection because of its many parallels to 9/11 relief funds.

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available benefits and services. *Id.*

193. *See, e.g.*, Stephanie Strom, *Finding Cure for Hearts Broken Sept. 11 Is as Difficult as Explaining the Cost*, N.Y. TIMES, July 22, 2002, at B1, *available at* LEXIS, N.Y. Times file; *The Bombing*, CNN, *at* http://www.cnn.com/US/OKC/bombing.html. If Oklahoma City's ratio of slain victims to counseled persons were applied to 9/11 charities, then these entities would be providing counseling to approximately 643 people in 2009.

194. The September 11th Fund will spend up to $55 million on mental health care to those traumatized by 9/11. Strom, *supra* note 193.

195. *Id.*

196. MACMILLAN DICTIONARY OF MODERN ECONOMICS 106 (David W. Pearce ed., 1992) (defining "diminishing marginal utility" as "The phenomenon whereby it is assumed that the additional utility attached to an extra unit of any good diminishes as more and more of that good is purchased").

197. Boenhardt v. Loch, 107 N.Y.S. 786, 787 (Sup. Ct. 1907); *see also* Victims v. Funds, 715 F. Supp. 178 (W.D. Tex. 1989) (disaster victims are not legally entitled to have all the funds raised by a charitable DRO on their behalf); Huetter & Friedlander, *supra* note 85, at 226 ("[o]nce the basic necessities [of each member of the beneficiary class] have been met," the excess funds cannot be "prorated among the victims").

198. *See supra* notes 148-49 and accompanying text.

199. *See supra* notes 150-56 and accompanying text.

On December 19, 1981, eight volunteer sea rescuers (called "lifeboatmen" in England) from the Penlee lifeboat station lost their lives attempting to save another ship's crew off the coast of Cornwall, England.[200] This event prompted a huge outpouring of financial support for the lifeboatmen's families, which included five widows and twelve children.[201] Most contributions went to one of two funds: the Penlee Fishermen's Fund (£250,000), which was organized by the local fishermen's association,[202] and the Penlee Lifeboat Disaster Fund (£3.5 million), which was set up by the local government council (the "Council").[203] The Fishermen's Fund was a private trust and promoted itself as such from the outset; its founders' stressed that it was simply "a collecting bowl" for the lifeboatmen's families and made no mention of charity.[204] The monies it received were split evenly among the eight families (1/8 of total per family) quickly and with no fuss. The creators of the much larger Disaster Fund, by contrast, made conflicting statements about the entity's legal status in the first few days after they began to receive contributions.[205] Their equivocation invited confusion and discontent among some donors.

In the immediate aftermath of the shipwreck (from December 19 until December 21), donors spontaneously sent over £16,000 to the Council.[206] During this period, the fund lacked a formal legal structure and issued no solicitations. Three days after the disaster, on December 22, the Council issued a press release inviting contributions and declaring that "all money received will be distributed directly to families of the lifeboat crew."[207] However, on the following day, December 23, the Council issued a second press release announcing that all monies received would be held in a charitable trust, and that "the amount of income which the trustees could legally distribute to the bereaved was limited to their reasonable needs. . . ."[208] The Council indicated that it had already received enough to meet these needs. Even so, it was "willing and able to continue to receive [additional] donations but stressed that . . . these donations would be used for related charitable purposes."[209] In other words, any additional gifts would be

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200. John Mullen, *Ten Years After the Penlee Lifeboat Was Lost with All Hands*, GUARDIAN (London), Dec. 19, 1991, *at* LEXIS, Major Newspapers file. For more information on this incident, see http://www.penlee-lifeboat.co.uk.

201. Mullen, *supra* note 200.

202. Hubert Picarda, *Spontaneous Disaster Funds*, *reprinted in* ROGER W. SUDDARDS, BRADFORD DISASTER APPEAL 35 (1986).

203. Barbara Amiel, *Behind Disaster Funds Lie the Best Impulses of Human Nature, but the Minute There Is Money, Other Instincts Surface*, TIMES (London), Sept. 4, 1987, *available at* LEXIS, Major Newspapers file.

204. Tim Dickson, *Sweet Charity for Mousehole*, FIN. TIMES (London), Jan. 9, 1982, at 5, *at* LEXIS, Fin. Times file.

205. *Id.*

206. Picarda, *supra* note 202, at 35.

207. *Id.*

208. *Id.* (paraphrasing the Dec. 23 press release).

209. *Id.*

treated as surplus and redeployed via cy pres or cy pres-like principles.

The vast majority of the Disaster Fund's £3.5 million were raised after the trustees declared its charitable nature. Yet many donors apparently did not hear, heed, understand or concur with the council's second press release. Most contributors, *The Financial Times* reported, "wished *all* the cash (*however much*) to end up in the hands of the lost lifeboatmen's families."[210] These donors wanted the Disaster Fund to operate like a private trust (i.e., able to distribute aid without regard to need), but avoid being treated as such for tax purposes.[211] The thought of Disaster Fund monies being taxed or diverted to other charitable purposes angered some contributors, media commentators, and members of Parliament.[212] "A vast amount of the money given in sorrow and sympathy in pubs, clubs and on the street, raised by sponsored walks, rides, rowing, football and rugby matches, special concerts, from official societies and humble individuals . . . would go whistling into the jaws of the taxman.[213] To douse this firestorm, the attorney general formally classified the Disaster Fund as a private trust while at the same time exempting it from most of the unfavorable tax consequences of noncharitable status.[214] According to one observer, the attorney general's decision laid bare the Disaster Fund's true purpose: to give money "to the families as a tribute to their dead menfolk, in recognition of the way they had given their lives."[215] Because it was rewarding heroism instead of relieving need, the trustees determined that "[t]he only fair way to distribute this [money] was simply to divide it eight ways and pass it on."[216]

The Penlee experience is intriguing, but is it a viable model? How readily could public officials in the United States retroactively redesignate an oversubscribed DRO as a private benefit organization, in order to avoid a need-based ceiling on the payout to victims? For entities already exempt under I.R.C. section 501(c)(3), this option is unavailable. By accepting 501(c)(3) status, these entities unequivocally and irrevocably dedicated their assets to charitable purposes and thus agreed to comply with the ban against private benefit. However, the Penlee option might be available when donors spontaneously contribute to a legal nonentity or an amorphous unincorporated association without seeking a charitable deduction. It might also apply when legally

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210. Dickson, *supra* note 204 (emphasis added).

211. If the fund was organized as a private trust, it would have to pay income taxes on the interest generated by contributions, and such contributions would be subject to the capital transfer tax. Dickson, *supra* note 204.

212. Amiel, *supra* note 203.

213. MICHAEL SAGAR-FENTON, PENLEE: THE LOSS OF A LIFEBOAT 77 (Truran 2000).

214. *Lifeboat Fund Ruling Favours Dependants*, FIN. TIMES (London), Jan. 6, 1982, at 6, *available at* LEXIS, Fin. Times file.

215. SAGAR-FENTON, *supra* note 213, at 77-78. *See also* Editorial, TIMES (London), Jan. 9, 1982, *reprinted in* SUDDARDS, *supra* note 202, at 31 ("People gave money out of admiration for the men who gave their lives, out of pity for their families, and out of gratitude to lifeboatmen all round our coasts.").

216. SAGAR-FENTON, *supra* note 213, at 78.

unsophisticated people solicit contributions without creating or affiliating with any formal organization, except perhaps a bank account to deposit contributions.[217] In such cases, the donee's status may be sufficiently ambiguous as to permit officials to plausibly characterize or recharacterize it as private.

II. CAN WE GIVE IT ALL, AND HOW? THE PREDICAMENT OF OVERSUBSCRIBED 9/11-SPECIFIC CHARITIES

Over 300 charitable organizations raised funds for 9/11 relief, with thirty-five entities receiving the bulk of donated funds.[218] In the first two months after the attacks, the largest charities raised more than $1.3 billion, while distributing a relatively small portion of this sum.[219] Inevitably, some victims and observers complained that charities were giving out the funds too slowly. What was the hold-up? What accounted for the gap between donations received and disbursements made?

Beyond the logistical challenges, some of the largest 9/11 DROs found themselves caught between competing legal and ethical obligations: the altruistic yet potentially noncharitable intentions of many donors, and legal limits on the entity's ability to provide financial assistance. The conflict was most severe for charities that collected very large sums to distribute to a relatively small number of intended beneficiaries. These organizations faced increasingly strident demands from donors, victims, and critics to distribute everything promptly and costlessly. The directors of some charities feared they could not simultaneously meet these demands while complying with the legal requirements to assess financial need and redeploy any surplus. The result was a logjam that deterred several major 9/11 charities from dispensing much aid, if any.[220]

The impasse was broken when the IRS exempted 9/11 charities from the duty to assess financial need before disbursing cash assistance.[221] This exemption, which Congress subsequently enacted into law, enabled these charities to escape

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217. LAW REFORM COMMISSION OF BRITISH COLUMBIA, REPORT ON INFORMAL PUBLIC APPEAL FUNDS 26, *available at* http://www.bcli.org/pages/publications/lrcreports/repsum129.html (last visited Sept. 7, 2002).

218. U.S. GAO, *September 11 Report*, *supra* note 2, at 2. The largest recipients of private donations include the American Red Cross Liberty Fund (over $1 billion); the September 11th Fund ($512 million); the Twin Towers Fund ($205 million); the International Association of Fire Fighters' New York Firefighters 9-11 Disaster Relief Fund ($161 million); the Citizens' Scholarship Foundation ($113 million); the Salvation Army ($87.7 million) (as of July 31, 2002); the Uniformed Firefighters Association ($71 million) (as of July 31, 2002); the New York State World Trade Center Relief Fund ($68.7 million); and the New York City Police Foundation's Heroes Fund ($11 million). These amounts were current as of October 31, 2002, unless noted otherwise. *Id.* at 35-36.

219. David Barstow & Diana B. Henriques, *A Nation Challenged: The Charities; I.R.S. Makes an Exception on Terror Aid*, N.Y. TIMES, Nov. 17, 2001, at B1.

220. *Id.*

221. *Id.*

a tight spot.[222] The practical effect of this exemption was to permit 9/11 DROs to operate like private trusts for attack victims and to pay significantly more to families with higher pre-9/11 standards of living than those who had lived more modestly.

A. Eligibility for Relief: Defining the Beneficiary Class

DROs created exclusively for 9/11 victims used different criteria to define their intended beneficiaries. The narrowest and most definite are the funds established exclusively for families of the following groups: the twenty-three fallen members of the New York City Police Department; the 347 fallen firefighters and Emergency Medical Services (EMS) personnel who died in New York;[223] the rescue workers who died in New York (fire, police, EMS, etc.); and those killed at the World Trade Center, the Pentagon, or on Flight 93.[224] Other charities reserved more discretion from the outset to allocate aid among those harmed by the attacks. The September 11th Fund, for example, was created "to meet the immediate and long-term needs of [9/11] victims, families and communities."[225] This broad mandate enabled the charity to extend help to displaced workers and residents, rescue workers, and affected small businesses and nonprofit organizations.[226] Still other charities experienced "mission creep" as the donated sums grew. When The New York Times 9/11 Neediest Cases Fund was announced two days after the attacks, its stated goal was "to help those injured in the attack or the families of those who died."[227] Within days, the fund also began focusing on lower-income workers who lost jobs.[228] Within six weeks, the fund had made grants for such things as "therapeutic after-school programs for children who attend schools near the trade center site" and

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222. *See infra* note 255 and accompanying text.

223. The New York Firefighters 9-11 Disaster Relief Fund has benefited survivors of 347 union members. Telephone Interview with George Burke, Assistant to the General President for Communications and Media, International Association of Fire Fighters, Washington, D.C. (Apr. 10, 2001) [hereinafter Burke Telephone Interview] (on file with author).

224. *See, e.g.*, New York State World Trade Center Relief Fund, *at* http://www.helping.org/wtc/ny/nystate.htm (last visited July 12, 2002). Although funded with private donations, this is not a charity; the New York State Department of Taxation and Finance established and administers it. U.S. GAO, *September 11 Report*, *supra* note 2, at 35-36 & n.e.

225. A description of the Fund is available at http://www.September11fund.org/aboutus.php (last visited Feb. 8, 2003).

226. *See id.*

227. Aaron Donovan, *After the Attacks: Charity; How to Help the Neediest of Cases*, N.Y. TIMES, Sept. 13, 2001, at A11, *available at* LEXIS, N.Y. Times file; *see also* Editorial, *Helping the Victims*, N.Y. TIMES, Sept. 13, 2001, at A26, *available at* LEXIS, N.Y. Times file.

228. *See, e.g.*, Aaron Donovan, *After the Attacks: The Neediest; Disaster May Tax Charities*, N.Y. TIMES, Sept. 14, 2001, at A13, *available at* LEXIS, N.Y. Times file; Aaron Donovan, *A Nation Challenged: The Neediest; Gifts from The Rich, and Lemonade Stands*, N.Y. TIMES, Sept. 18, 2001, at B8, *available at* LEXIS, N.Y. Times file.

community mental health more generally.[229] By way of explanation, the fund's president said that "[r]eader generosity has been so great that it appears we'll be able to meet all of those direct service needs and also address larger structural needs."[230]

B. Tension Between Donor Intent and Legal Limits on Assistance

In the two months following the attacks, some of the most prominent 9/11 DROs seemed unable to deliver enough assistance fast enough to satisfy their constituencies and observers.[231] Such complaints were inevitable so long as charities distributed cash gifts under the traditional approach, namely, by assessing each applicant's ability to meet basic and immediate living expenses.[232] The IRS's guidance on disaster relief appeared to dictate this approach. On September 17, 2001, the IRS posted on its website the advanced text of a special publication on providing disaster relief through charitable organizations.[233] This publication cautioned that "charitable funds cannot be distributed to persons merely because they are victims of a disaster."[234] Rather, any disbursements "must be based on an objective evaluation of the victims' needs at the time of the grant."[235] More specifically, DROs could give cash only to those who lacked adequate resources to meet their current financial and medical needs and those needs likely to arise in the immediate future. If DROs wished to provide a safety net for victims who *were* able to meet their short-term needs, they could set aside funds to meet longer-term needs if and when such needs arose.

Against this backdrop, some of the largest 9/11 DROs deferred making major

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229. Aaron Donovan, *A Nation Challenged: Charity; Disaster Fades into the Past, but Generosity Does Not*, N.Y. TIMES, Oct. 27, 2001, at B10, *available at* LEXIS, N.Y. Times file; *see also About the 9/11 Neediest Fund*, *available at* http://www.nytco.com/company/foundation/nine11.neediest.html (last visited July 12, 2002).

230. Donovan, *supra* note 229, at B10 (quoting Jack Rosenthal, president of The New York Times Company Foundation, which administers the fund).

231. Robert Ingrassia & Michael Saul, *More Heat for UFA; Bizman Joins Protest Over 60M WTC Fund*, N.Y. DAILY NEWS, May 10, 2002, at 6 (quoting president of company that donated to firefighters charity saying that "[e]verybody gave with the intention that the money would go to the families in a timely manner. It wasn't intended to be a slow trickle out").

232. *See, e.g.*, New York Firefighters 9/11 Disaster Relief Fund, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, Form 1023, Schedule A, Part I, 1 (Sept. 21, 2001) (on file with author) (assuring the IRS that "[t]he amounts distributed to each [eligible] family [of a fallen firefighter] will be determined on the basis of such family's needs [i.e., ability to meet basic living requirements] at the time of grant"); Burke Telephone Interview, *supra* note 223 ("We are a union. We were not equipped to do a needs-based process" in making distributions from the New York Firefighters 9/11 Disaster Relief Fund).

233. IRS, *supra* note 190.

234. *Id.*

235. *Id.*

disbursements until the legal situation was sorted out.[236] As of October 28, 2001, the Twin Towers Fund had distributed none of the $71 million it had collected for families of the uniformed rescue personnel killed in New York.[237] As of November 6, 2001, the New York Firefighters 9-11 Disaster Relief Fund had distributed only a tenth of the $63 million it had raised.[238] Its initial payments consisted of a $20,000 gift to each of the families of fallen firefighters and paramedics.[239] A spokesman for the Fund stated that the Fund would refrain from making additional disbursements until it developed "criteria to ensure that the families[']humanitarian needs will be met in an manner consistent with our fiduciary duties and applicable law including the Internal Revenue Code."[240] This situation led to exasperation, suspicion and accusations: why were these charities sitting on all the money?

Other charities followed the IRS policy by providing cash for short-term needs based on demonstrated financial distress and by setting aside funds for long-term needs. This response mitigated, but did not eliminate, the glaring disparity between amounts donated and disbursed. The charities could only move so fast. The process of assessing need can be both labor-intensive and highly delicate: a charity may need to use trained volunteers or professionals to identify victims, sort them by relative and specific need, and match the charity's resources to meet the most urgent needs.[241] Charity personnel may have to ask applicants some intrusive questions.[242] The application process invited complaints that 9/11 victims were being "victimized again" by paperwork and red tape.[243] Lastly, holding back some dollars for the victims' anticipated future

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236. Susan Edelman, *Good Sams Plead with Uncle Sam for Equal Handout of WTC Charity*, N.Y. POST, Oct. 28, 2001, at 6 ("officials [of New York Firefighters 9-11 Relief Fund] fear they won't be able to evenly distribute the remaining $46 million without jeopardizing the fund's tax-exempt status."); Diana B. Henriques & David Barstow, *A Nation Challenged: The Charities; Victims' Funds May Violate U.S. Tax Law*, N.Y. TIMES, Nov. 12, 2001, at B1; I.R.S. Notice 2001-78; 2001-50 I.R.B. 1 (Nov. 16, 2001), *reprinted at* TAX NOTES TODAY 223-6 (Nov. 19, 2001) ("Several charities have raised questions about the practical application of existing legal standards for distributing funds to victims of the September 11, 2001 terrorist attacks").

237. Edelman, *supra* note 236.

238. *Id.*

239. Greenwood hearing, *supra* note 2 (remarks of Vincent Bollon, Secretary Treasurer of the International Association of Fire Fighters (IAFF)).

240. *Id.*

241. Bjorklund, *supra* note 9, at 15-16.

242. *See* Heutter & Friedlander, *supra* note 85, at 50 (specifying information DRO should obtain before awarding long-term financial assistance).

243. *Charitable Organizations' Distribution of Funds Following the Recent Terrorist Attacks: Hearing Before the House Ways and Means Committee, Subcommittee on Oversight* (Nov. 8, 2001) (testimony of Eliot Spitzer, New York State Attorney General), *available at* 2001 WL 1400781. *See also* Janny Scott, *A Nation Challenged: The Paperwork; Awash in Grief After Attack, Adrift in a Sea of Paperwork*, N.Y. TIMES, Nov. 20, 2001, at A1 (describing a widow's ordeal sorting through "the birth certificates, marriage certificate, death certificate, mortgage papers, pay stubs,

needs was unpopular because, as a general proposition, most donors expect their gifts to be used for current programs rather than placed in reserve.[244]

To speed the cash outlays, some asked that charities be permitted to operate in ways that contradicted charity law principles and IRS guidance. Most notably, some proposed that charities be permitted to give each intended beneficiary a fractional share of the total amount the charity raised (as was done with the Penlee Lifeboat Disaster Fund) or an amount based upon each surviving family's composition (e.g., a certain sum for a surviving spouse, another fixed amount for each dependent child).[245] Even so, many found the case compelling for several reasons: to minimize administrative costs; to avoid having to return gifts which might make them foolish; and to avoid having to use gifts for other charitable purposes which would anger those donors who wished to help 9/11 victims regardless of financial need.

Donors always want charities to minimize administrative costs. After 9/11, however, many donors apparently expected such costs to disappear.[246] Ironically, the deluge of donations that followed 9/11 may have made it costlier for charities to distribute aid using traditional approaches. As between two disaster victims, it is generally easier to identify who needs items such as food, clothing, and shelter most desperately. Unlike most relief operations, 9/11 charities seem to have raised more than enough money to meet everyone's basic physiological needs. As victims ascend Maslow's hierarchy of needs, it becomes increasingly costly to assess relative need. As between two aid applicants, it is can be difficult if not impossible to determine who needs additional esteem, love, self-actualization, etc., most urgently.

It was also argued that 9/11 charities were simply receiving "too much money . . . for too few survivors for typical guidelines to apply."[247] Charities created exclusively for the families of rescuers were raising the most money per

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correspondence, checklists, current bills and innumerable, interminable applications for help"); Transcript, The O'Reilly Factor (Fox News television broadcast Nov. 13, 2001) (remarks of Bill O'Reilly) ("it'd be pretty callous . . . to ask people who are just burying their husbands or wives to provide a financial statement" to justify charitable assistance).

244. *See Full Text Testimony—Wise Giving Alliance Testimony at W&M Hearing on Charitable Groups' Reaction to Terrorist*, 34 EXEMPT ORG. TAX REV. 472 (Dec. 2001).

245. Henriques & Barstow, *supra* note 236; Scott, *supra* note 243.

246. This is reflected by the fact that so many 9/11 charities promised to spend the donor's gift on direct relief. Editorial, *Honor Donors' Intent*, N.Y. DAILY NEWS, June 15, 2002, at 18 ("Nonprofits surveyed said none of the Sept. 11 money is going to administrative costs"). *See also* Press Release, Twin Towers Fund, Mayor Giuliani Announces First Wave of Initial Distribution to Aid Families of Uniformed Service Personnel (Nov. 9, 2001), *available at* http://www.twintowersfund.org/news_1109_01.html (last visited Jan. 31, 2003) ("All money raised by the Twin Towers Fund will go directly to the families of the Uniformed Service members who sacrificed their lives. A separate fund has been set up to raise money for administrative costs so that all the money donated by individuals and corporations to the relief effort will go directly to these families.").

247. Bjorklund, *supra* note 9, at 18.

victim: $353 million by December 2001, or around $880,000 per family.[248] These charities were also the most concerned about the tax consequences of their disbursements.[249] Given the other sources of aid available to such families, these charities were indeed challenged to find many intended beneficiaries in long-term financial distress.[250] For example, the City of New York pays the surviving spouses of fallen officers a full pension equal to the decedent's lost salary,[251] a $25,000 death benefit, and a stipend equal to one year's salary.[252] Children of fallen officers receive full scholarships to New York State universities.[253] The United States Department of Justice makes a lump-sum payment of $259,000 to the eligible survivors of each police and fire personnel killed in the line of duty.[254] Lastly, the September 11th Victim Compensation Fund of 2001 ("VCF") will make an average payment of $1.5 million to each 9/11 decedent's beneficiary, after offsets for things like insurance proceeds and pension benefits.[255] Even with maximum offsets, the VCF will pay each eligible beneficiary a minimum of $250,000, plus an additional $100,000 for each surviving spouse and dependant.[256] As a result of this compensation from collateral sources, many survivors of fallen rescuers will ultimately be better off in strictly financial terms after 9/11 than before, notwithstanding the loss of the primary breadwinner.[257] The result has given rise to a new need, one that DROs typically do not address: financial counseling to help victim-beneficiaries manage their new-found wealth.[258] Unless the IRS's needy and distressed test

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248. Charities dedicated solely to helping police and fire families ultimately raised more than $500 million—approximately $1.25 million per family. Robert Ingrassia, *Police & Fire Widows to Get $2 M; WTC Victims' Kin to Share in $500M*, N.Y. DAILY NEWS, May 16, 2002, at 8. Families of slain civilians would generally receive much less, because the remaining funds had to be spread over a much larger number of people. David Barstow & Diana B. Henriques, *A Nation Challenged: The Families; Gifts to Rescuers Divide Survivors*, N.Y. TIMES, Dec. 2, 2001, at A1.

249. Barstow & Henriques, *supra* note 219.

250. *See* Edelman, *supra* note 236 (quoting Joseph Mancini, a spokesman for the New York Patrolmen's Benevolent Association: "I don't see how police and firefighters' survivors could be classified as needy. They'll be taken care of for the rest of their lives.").

251. Barstow & Henriques, *supra* note 248, at A1.

252. Ingrassia, *supra* note 248, at 8.

253. *Id.*

254. *See* http://www.ojp.usdoj.gov/BJA/topics/PSOBProgram.html (last visited July 17, 2002) (Public Safety Officer's Benefit Program).

255. David W. Chen, *Victims' Fund Announces First Awards*, N.Y. TIMES, Aug. 23, 2002, at B1. However, there will be no offsets for charitable gifts. 28 C.F.R. § 104.47(b)(2) (2003).

256. 28 C.F.R. § 104.44.

257. *See* Mike Claffey, *Battle Over $60M Fund: Grieving Survivors in Clash with Firefighters Union*, N.Y. DAILY NEWS, May 9, 2002, at 5 (quoting firefighter's widow saying that "[c]ertainly, I have more money than I had, but I have a lot more troubles than I ever had. I would be glad to trade places [with those people who suggest I'm greedy for more assistance]").

258. *See* Lisa Fickenscher, *Fears of Money Scams Grow; Few 9/11 Families Seek Advice to Handle $1 Billion in Payments*, CRAIN'S N.Y. BUS., Apr. 15, 2002, at 1 (experts express fear that

was relaxed, some DROs devoted solely to rescuers would likely have been unable to avoid a surplus—a true embarrassment of riches.

Needs-testing of 9/11 victims also seemed inapt on another ground: many donors contributed for reasons other than simply relieving the victims' suffering. This was especially true for charities formed solely to benefit the families of fallen rescue workers. As in the Penlee lifeboatmen's case, some donors contributed in order to honor the rescuers' heroism.[259] Some frankly sought to enrich the survivors' financial condition as solace for, or in solidarity with, their loss. This is evidenced by the fact that many donors gave to rescuer charities even after it had become clear that this group of survivors' basic needs had been met. If their gifts helped make these families millionaires, some donors felt, then "so be it."[260]

The conflict between the donors' desires and the rules restricting their realization peaked the second week of November 2001. On November 8, 2001, the House Ways and Means Oversight Subcommittee held a hearing to investigate complaints about 9/11 charities. At this hearing, Steven Miller, Director of the IRS's Exempt Organizations Division, reiterated the IRS's position, testifying that:

> Merely being present at the scene of a disaster does not establish a need for assistance .... Money collected even for a specific disaster must be distributed based on a determination by the charity that it is meeting the needs of disaster victims. The charity's funds cannot be distributed among the victims simply on a pro-rata basis because that method is not based on meeting individual victims' needs.[261]

The day after this hearing, the Twin Towers Fund announced that it had begun distributing $40 million to the families of 400 or so fallen uniformed personnel.[262] The Fund acknowledged that it was issuing these checks, which

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9/11 families "have either not sought [financial] advice or are receiving it from incompetent or sources"); Michele McPhee & Robert Ingrassia, *One Widow's Struggle With Finances*, N.Y. DAILY NEWS, Dec. 2, 2001, at 7 (discussing difficulties of firefighter's widow who "had to learn how to deal with a lot of money").

259. *See, e.g.*, Barstow & Henriques, *supra* note 248 (many Americans yearned "to reward the indisputable heroism of rescuers who marched into two burning towers"); Barstow & Henriques, *supra* note 219 (the fallen rescuers, declared Mayor Giuliani, deserved everything a generous nation wished to give to honor their heroism and sacrifice).

260. *See, e.g.*, Henriques & Barstow, *supra* note 236 (the attitude of many donors regarding the "heroes fund" for families of slain New York City police officers was that "if it makes [the recipients millionaires], then so be it").

261. *Charities Response to Set [sic] 11: Hearings on Response by Charitable Organization to the Recent Terrorist Attacks Before the Subcommittee on Oversight of the House Committee on Ways and Means* (Nov. 8, 2001) [hereinafter *Charities Response*] (statement of Steven Miller, Director, Exempt Organizations, Tax Exempt/Government Entities Division), *reprinted in* 2001 TAX NOTES TODAY 218-34 (Nov. 9, 2001).

262. Henriques & Barstow, *supra* note 236.

averaged $114,000, without assessing the recipients' needs on a case-by-case basis.[263] These disbursements, city officials stated, "honor[ed] the wishes of millions of donors to reward the heroic sacrifices of so many families."[264]

In the end, the IRS's efforts to get DROs to assess victim need before disbursing and proved to be politically unsustainable.[265] Critics accused the IRS of stopping up the pipeline of assistance from generous Americans to attack victims.[266] This of course was not the issue: donors always had the option of making non-deductible contributions to non-exempt private trusts.[267] The issue was whether donors could donate tax-deductible dollars to tax-exempt organizations that did not screen financial aid applicants for financial need. Critics such as *The Wall Street Journal* editorial board answered "yes" and claimed to speak for most Americans.

> The IRS's philanthropy czars insisted that charities could not give money to people "merely because they are victims of a disaster" such as September 11 . . . "An affected individual generally is not entitled to charitable funds without a showing of need," the IRS's Steven Miller recently told Congress. And merely losing a lifetime partner and breadwinner doesn't qualify as enough of a "need" in IRS World.
>
> Mr. Giuliani [creator of the Twin Towers Fund], and we dare say most Americans, evidently believe otherwise. They think Americans ought to be able to help other Americans without first making them beg . . . .
>
> The widow of a Cantor Fitzgerald bond trader living in a $450,000 house in the New Jersey suburbs may look wealthy. But with three kids, a huge mortgage and the family breadwinner buried in the rubble of the Twin Towers, those children had better be good athletes or they won't be going to college.[268]

A week after the hearings, the Senate unanimously added an amendment to a

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263. *Id.*

264. *Id.*

265. Lee A. Sheppard, *News Analysis—Was the IRS Reversal on Charity Necessary?*, 93 TAX NOTES 1138, 1142 (Nov. 26, 2001) ("The general interest press, egged on by elected officials, loves to portray the IRS as ogres. Unfortunately, sometimes the IRS inadvertently assists them in that portrayal. November 8 was one of those days.") *Id.* at 1138.

266. *See, e.g.*, Henninger, *supra* note 3, at A12 ("None of the 9/11 charities wants to get into trouble, so the money sits until some fat bureaucrat sings").

267. Steven Miller made this point during his congressional testimony: "If members of the public want to help particular individuals, they can simply give the money directly to the victims or through an organization that is not a qualified charity." *Charities Response*, *supra* note 261 (prepared testimony of Steven Miller, Director, Exempt Organizations, Tax Exempt/Government Entities Division).

268. *Review & Outlook: Charity Case*, WALL ST. J., Nov. 19, 2001, at A20, *available at* 2001 WL-WSJ 29678257.

pending bill that would enable charities to make larger, faster, and need-blind payments to 9/11 victims.[269] This amendment provided that:

> payments made by a [501(c)(3)-exempt] organization . . . by reason of the death, injury, wounding, or illness of an individual incurred as the result of the [9/11] terrorist attacks . . . shall be treated as related to the purpose or function constituting the basis for such organization's exemption . . . if such payments are made *in good faith using a reasonable objective formula which is consistently applied.*[270]

Stung by bad publicity and anticipating a legislative "veto," the IRS abandoned its position and followed the Senate's lead. On November 16, 2001, the Service announced that such payments would be presumed charitable so long as they were "made in good faith using objective standards."[271] Having been fingered as the logjam in private relief operations, the IRS changed its policy because, as Steven Miller explained, it "didn't want to get in the middle between the beneficiaries and the charities."[272]

C. Congress Breaks the Logjam

In December 2001, Congress enacted the Victims of Terrorism Tax Relief Act of 2001 (the "Act").[273] Section 104 of the Act provides that payments by 501(c)(3) organizations related to a person's "death, injury, wounding, or illness" in the 9/11 attacks are deemed to serve a 501(c)(3) exempt purpose if made "in good faith using a reasonable and objective formula which is consistently applied."[274] This standard synthesizes the Senate and IRS antecedents and adds a "reasonableness" requirement. Section 104's most important effect says the committee report that accompanied it was to release 501(c)(3) entities from the requirement "to make a specific assessment of [the recipient's] need" before disbursing funds to attack survivors.[275] The charitable conduit between donors and 9/11 victims would henceforth be unhindered by charity law's traditional

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269. Victims of Terrorism Relief Act of 2001, 147 CONG. REC. S11,991-11,994 (Nov. 16, 2001) (remarks of Sen. Baucus).

270. Victims of Terrorism Relief Act of 2001, Pub. L. No. 107-134, § 104, 115 Stat. 2427, 2431 (codified at 26 U.S.C. § 501 (2002)).

271. *See, e.g.*, Notice 2001-78; 2001-50 I.R.B. 1 (Nov. 16, 2001), *reprinted in* 2001 TAX NOTES TODAY 223-6 (Nov. 19, 2001) ("Several charities have raised questions about the practical application of existing legal standards for distributing funds to victims of the September 11, 2001 terrorist attacks").

272. Sheppard, *supra* note 265.

273. Pub. L. No. 107-134, § 104, 115 Stat. 2427, 2431 (codified at 26 U.S.C. § 501 (2002)).

274. 26 U.S.C. § 104(a) (2000) (emphasis added). The exemption also applies to payments made in connection to "an attack involving anthrax occurring on or after September 11, 2001, and before January 1, 2002." *Id.*

275. JOINT COMMITTEE ON TAXATION, 107TH CONGRESS, TECHNICAL EXPLANATION OF THE "VICTIMS OF TERRORISM TAX RELIEF ACT OF 2001 (Comm. Print 2001).

requirements.

The report of the Joint Committee on Taxation ("Committee") expressly endorses the two methods for distributing aid proposed after 9/11. Under the first approach, a DRO can divide the money it raises by the number of relevant decedents and give each decedent's family the same amount.[276] This approach results in smaller per capita awards (i.e., payment per family member) for larger families. Alternatively, a charity can give each decedent's family an amount based on the number of members or dependents.[277] This results in equal payments for every family member irrespective of family size.

Both approaches yield arithmetically equal gifts to both rich and poor applicants alike in similarly constituted families. Other facially "objective" approaches can result in larger gifts to families that lost higher income earners. An "objective formula [which is consistently applied]," one commentator observed, "could encompass many things, like pre-existing living expenses."[278] Using the family's pre-9/11 income or living standard as its lodestar, a charity might:

> award aid based on the notion that those who have more get more. To say "the family that earns $300,000 a year should get 10 times as much as the family that earns $30,000 a year"—that would be objective in the sense that if you earn a lot of money then your expenses are high and therefore you should get proportionately more help.[279]

The Committee report initially seems to disapprove of this result, stating that:

> It would not be appropriate for a charity to make pro-rata payments based on the recipients' living expenses before September 11 if the result generally is to provide significantly greater assistance to persons in a better position to provide for themselves than to persons with fewer financial resources. Although such a distribution might be based on objective criteria, it would not, under the statutory standard, be a reasonable formula for distributing assistance in an equitable manner.[280]

Note that the report does not categorically reject distributions tied to a victim's

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276. "A charitable organization that assists families of firefighters killed in the line of duty could make a *pro-rata* distribution to the families of firefighters killed in the attacks." *Id.* (emphasis added).

277. *Id.* ("If the amount of a distribution is based on the *number of dependents* of a charitable class of persons killed in the attacks and this standard is applied consistently among distributions, the specific needs of each recipient do not have to be taken into account") (emphasis added). *See also Disaster Relief* (final text), *supra* note 126, at 12. "Even though payments vary between families, because the formula is based on the number of family members, the method is considered . . . objective."

278. Sheppard, *supra* note 265.

279. Elizabeth Schwinn, *Easing of IRS Policy Lets Relief Groups Disburse Funds Regardless of Need*, CHRON. PHILANTHROPY 30 (Nov. 29, 2001).

280. JOINT COMMITTEE ON TAXATION, *supra* note 275.

pre-9/11 living expenses. Rather, it frowns upon a mechanical approach that ignores collateral sources available to victims. The widow living in the $450,000 home should not *necessarily* receive ten times more than the widow living in the $45,000 mobile home, as she may have more post-9/11 financial resources to draw upon in terms of savings, real and personal property, life insurance payouts, pensions, etc.

Yet the report next discusses cases where it would be appropriate for charities to give more aid to families with higher pre-9/11 expenses:

> [P]ayments to permit a surviving spouse with young children to remain at home with the children rather than being forced to enter the workplace seem to be appropriate to maintain the psychological well being of the entire family. Similarly, assistance with elementary and secondary school tuition to permit a child to remain in the same educational environment seems to be appropriate, as does assistance needed for higher education. Assistance with rent or mortgage payments for the family's principal residence or car loans also seems to be appropriate to forestall losses of a home or transportation that would cause additional trauma to families already suffering.[281]

In distributing aid to two families with no collateral resources, a charity can sometimes distribute more to the family whose standard of living was based on, say, a $300,000-a-year earner ("Family A") than a $30,000-a-year salary earner ("Family B"), when such payments shield Family A from the added stress of adjusting to a lower standard of living. This adjustment might entail such things as selling the $450,000 house, moving to smaller quarters and transferring the children from a private school to a public school. This result is fair insofar as Family A is more vulnerable than Family B to the stress of *déclassément*: having lived at a higher level, it has farther to fall. It is unclear whether disparate payments may be maintained indefinitely, or for a limited time only in order to ease Family A's descent to a lower standard.

Lastly, is there an upper limit to how much DROs can pay to any given family under the Act, so long as the amount is determined using an objective and consistent formula? A charity complies with the Act, the IRS has advised, if it "is using objective distribution criteria that take into account all pertinent circumstances, *including the size of the amounts distributed*, to avoid impermissible private benefit."[282] The IRS appears to locate this spending ceiling in the Act's requirement that 9/11 distributions be "reasonable," which the IRS connects to the private benefit doctrine. That doctrine, as Judge Posner has

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281. *Id.* at 12. *See also* Scott, *supra* note 243 (widow explaining that "it's important that we keep our home because [my deceased husband] loved this home very much. This was his dream home, and he did a lot of work here himself. He had his heart and soul in here. This is the place that makes us feel safe. And I feel like, if I leave here, I'll be leaving part of him.").

282. *Disaster Relief* (final text), *supra* note 126, at 7 (emphasis added). The IRS has stated that it interprets good faith under the Act to mean that "the charity is applying its best efforts to accomplish its charitable purpose." *Id.*

suggested, is a "route for using tax law to deal with the problem of improvident or extravagant expenditures by a charitable organization that do not, however, inure to the benefit of insiders."[283] Although the IRS has essentially declared that payments to 9/11 families cannot be extravagant, it does not appear to have enforced this principle. Given the IRS's earlier experience in attempting to curtail the liberality of 9/11 relief, one suspects that it will not try.

D. How 9/11 Charities Distributed Financial Aid

Section 104 of the Victims of Terrorism Tax Relief Act released DROs from the duty to assess need before distributing long-term financial aid to 9/11 victims. How did charities exercise this freedom?

1. Equal Shares Per Decedent.—The fourth-largest 9/11 charity, the New York Firefighters 9-11 Disaster Relief Fund, elected to distribute an equal share of the total funds it collected to the named beneficiary or families of each of the 347 firefighters and EMS personnel killed at the World Trade Center.[284] It has distributed at least $418,000 for each decedent.[285] The firefighters' widows reportedly wanted equal shares in order to minimize the potential for conflict among them.[286] The union that operates the fund, the International Association of Fire Fighters (IAFF)[287], preferred an equal division in order to reduce its administrative costs.[288] The simplicity of this approach enabled the to union distribute 92% of the donated sums to survivors within nine months of the attacks.[289]

2. Payment Per Family Member.—The third-largest 9/11 charity, the Twin Towers Fund, has made payments based on the make-up of the fallen officer's family: $290,000 for each surviving spouse; $186,650 for the next of kin where there is no surviving spouse; $107,000 for each child twenty-three or younger; and $44,150 for each child twenty-four or older.[290] Compared to the equal shares

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283. United Cancer Council v. Comm'r, 165 F.3d 1173, 1179 (7th Cir. 1999) (dictum).

284. Burke Telephone Interview, *supra* note 223. By "named beneficiary," I mean the person whom the firefighter named as the payable-on-death beneficiary of his retirement and other FDNY benefits. This was typically the surviving spouse, children, parents, or siblings, in that order. *Id.*

285. Seessel, *supra* note 14.

286. Burke Telephone Interview, *supra* note 223.

287. The IAFF represents 245,000 professional firefighters and paramedics who serve 80% of the nation's population. Greenwood hearing, *supra* note 2, at 75.

288. Burke Telephone Interview, *supra* note 223 (stating "We are a union. We are not prepared to do a needs-based process").

289. *See* Editorial, *supra* note 246 (complaining that more than one-third of the monies collected by the top eleven 9/11 charities had not yet been distributed, and that "[other 9/11 charities] could learn from the [IAFF] fund").

290. Current as of December 20, 2002. *See* Press Release, *supra* note 246; Press Release, The Twin Towers Fund, Twin Towers Fund Announces Third Round of Distributions: $103 Million to 9/11 Family Victims (June 6, 2002), *at* http://www.twintowersfund.org/News.html; Press Release, The Twin Towers Fund, Twin Towers Fund Announces Third Round of Distributions:

approach, this scheme more likely reflects each family's relative financial needs, all things being equal.[291] Younger children receive 2.4 times more than older children because they presumably depended more heavily on the decedent for support. The New York State World Trade Center Relief Fund makes this connection explicit. It provides $7500 for every decedent's child age twenty-one or younger.[292] A child over age twenty-one can receive this sum only if the decedent was the source of at least 50% of his or her financial support.[293]

3. Living Expenses.—The Salvation Army undertook to pay the household bills of survivors, displaced residents, and unemployed workers.[294] Under its guidelines, the Army paid up to $2000 a month in rent or mortgage and up to $750 for all other household bills (e.g., utilities, phone, insurance premiums, moving costs, minimum payment on a credit card).[295] For displaced residents, it paid up to $4000 of their moving costs.[296] Such assistance was ostensibly distributed "on a need basis,"[297] as determined by an Army caseworker. In practice, the Army generally deferred to the applicant's own assessment of his or her needs, and routinely exceeded its guidelines.[298] In either case, the Army's scheme provided more financial assistance to people with more expensive residences (i.e., with higher pre-9/11 standards of living), but only up to a cap.

4. Financial Need Assessed on a Case-by-Case Basis.—Although the Act permits 9/11 charities to ignore financial need, they are not obliged to do so.[299]

Additional $38 Million to 9/11 Family Victims (Dec. 20, 2002), *at* http://www.twintowersfund.org/News.html.

291. *See, e.g.*, Karl Marx, *Critique of the Gotha Program*, THE MARX-ENGLES READER 530-31 (Robert C. Tucker ed., 2d. ed. 1978) (criticizing the notion of distributing to each worker an equal share of the social consumption fund on grounds that, *inter alia*, "one worker is married, another not; one has more children than another," so that equal shares mean that "one will in fact receive more than another, one will be richer than another").

292. Press Release, New York State Office of the Governor, Governor Pataki: Governor Announces Release of $20 Million in WTC Relief Funds (Aug. 20, 2002), *at* http://www.state.ny.us./governor/press/year02/Aug20_1_02.htm.

293. *Id.*

294. Approximately 15,000 families took advantage of this offer. Chaka Ferguson, *Salvation Army Has Trouble Paying Bills for Those Affected by Sept. 11*, Associated Press State & Local Wire (Jan. 5, 2002).

295. E-mail Interview with Alfred J. Peck, Director, Social Services for Families and Adults, Salvation Army (Mar. 21, 2002) [hereinafter Peck E-mail Interview] (on file with author).

296. Press Release, Salvation Army, A Community of Unity—Salvation Army Helps WTC Victims Get Back on Their Feet (Nov. 7, 2001).

297. Peck E-mail Interview, *supra* note 295.

298. *Id.* ("Need was determined by the person asking for help.").

299. *See Disaster Relief* (advanced text), *supra* note 86, at 8 ("Those charities providing assistance to September 11 . . . victims may use the special rule that allows for formula-based distributions without a specific need assessment. However, they do not have to use this rule when making payments. Charities can still make an assessment of need when making payments to victims, recognizing their unique circumstances.").

One of the largest such entities, the Families of Freedom Scholarship Fund ("Scholarship Fund"), has elected to distribute aid the traditional way. The Scholarship Fund was created to provide tuition assistance to "financially needy dependants" of those killed on 9/11 or injured in the attacks and subsequent rescue and recovery operations.[300]

The Scholarship Fund, which has raised $105 million, is a separate fund operated by the Citizens' Scholarship Foundation of America (CSFA), a prominent general educational charity.[301] Given the prodigious sums raised, combined with the generous compensation and charity for 9/11 victims from other sources, one wonders how many needy applicants the organization will ultimately be able to identify.[302] Unlike other 9/11 charities, however, CSFA prepared for the possibility of insufficient or extinguished need at the outset. The Scholarship Fund's founding instrument states that:

> The [CSFA's] Board of Directors . . . may *redirect any excess assets* of the Fund to support other postsecondary education scholarship programs of [CFSA], on the good faith determination of at least two-thirds of the directors that the needs of the [9/11] victims' dependents have been met, or can with reasonable certainty be met with less than all of the assets of the Fund. In any event, any assets remaining in the Fund as of December 31, 2030, may be used by [CFSA] to support other postsecondary education scholarship programs . . . .[303]

The Scholarship Fund's declaration is a model of foresight and forthrightness. It plans for a possible surplus and how to declare and redeploy it. It also puts an outer limit on "deadhand" control by lifting the 9/11 restriction twenty-nine years, at which point the balance becomes part of CSFA's general program.[304]

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300. Citizen's Scholarship Foundation of America, Inc., Families of Freedom Scholarship Fund Overview, *at* http://www.familiesoffreedom.org/overview.php3 (last visited Aug. 22, 2002). There are approximately 4750 children under the age of twenty-three and about 1820 spouses are eligible to apply for these scholarships. E-mail from Barbara Arnold, Vice President, Public Affairs & Communications, Citizens' Scholarship Foundation of America (July 17, 2002) (on file with author) (citing latest data available as estimated by Stanton Group, a national actuarial firm).

301. Press Release, Citizens' Scholarship Foundation of America, Families of Freedom Scholarship Fund Reaches Goal of $100 Million (Sept. 4, 2002), *at* http://www.csfa.org/pages/cs4ne.htm (last visited Sept. 5, 2002). CSFA founded the Scholarship Fund in partnership with Indianapolis-based Lumina Foundation for Education. *Id.*

302. On September 4, 2002, CSFA announced that its scholarship awards for 2002 ranged from $1000 per academic year for "students with little or no financial need" to $28,000 for those "with greater need," with an average award of approximately $13,100. *Id.*

303. Families of Freedom Scholarship Fund®, *Families of Freedom FAQ*, *at* http://www.familiesoffreedom.com/faq.php3 (last visited Aug. 22, 2002).

304. *Id.* For another example of a fund making express provision for a possible surplus up front, see the fund discussed in note 181.

E. Responding to and Preventing Oversubscription

By any reasonable account, some 9/11-specific DROs raised more money than required to meet their intended beneficiaries' basic needs. This precipitated a crisis when many donors—as well as victims, media commentators, and members of Congress—demanded that charities disburse everything raised, "surplus" and all, to the victims, charity law and policy notwithstanding. Congress ultimately resolved this predicament by permitting charities to "reason not the need,"[305] so to speak, in distributing aid to 9/11 victims. What would have happened had Congress not intervened? How might this surplus situation have been avoided in the first place?

Because the largest 9/11-specific charities were 501(c)(3) entities, they could not have been formally recast as private trusts for the victims, as occurred in the Penlee Lifeboat Disaster Fund.[306] In the absence of special legislation, 9/11-specific charities could have disposed of any surpluses by: (a) spending the balance on providing in-kind services such as mental health; (b) holding funds in reserve, to be distributed in the future as needed; (c) asking a court for instructions. If the court determines that cy pres applied, the surplus could be redeployed to other charitable purposes. If not, then such funds would be returned to donors insofar as they could be identified. (d) General DROs had another option—to unilaterally apply the surplus to other disaster relief operations—except for gifts whose donors expressly provided for an alternate disposition of any surplus.[307]

As for the first two options, most 9/11 victims undoubtedly preferred over in-kind services and to receive it sooner rather than later.[308] With cash, they could procure precisely the goods and services they believed most likely to maximize their well being. Donors, motivated by unalloyed altruism, presumably wanted the same thing. One finds indirect support for this proposition from the fact that charities providing a great deal of in-kind services such as mental health care have felt more pressure than mainly cash-disbursing charities to justify this approach to their donors.[309] September 11 charities that made immediate payouts were also able to wind up their affairs more quickly and with less overhead.[310]

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305. WILLIAM SHAKESPEARE, KING LEAR act 2, sc. 4.

O reason not the need. Our basest beggars
Are in the poorest thing superfluous.
Allow not nature more than nature needs,
Man's life is cheap as beast's . . . .

306. *See supra* note 217 and accompanying text.

307. *See supra* notes 174-76 and accompanying text.

308. *See, e.g.*, Stephanie Saul, *Dispute Over Twin Towers Fund*, NEWSDAY (New York), Feb. 22, 2002, at A19 (firefighter union official opposed Rudolf Giuliani's plan to set up Twin Towers Fund with a staff of nearly a dozen and an annual administrative budget of up to $2.25 million: "If you have $100 million, divide it among the 400 families, pay it out, and we're done.").

309. Strom, *supra* note 193.

310. *See, e.g.*, Saul, *supra* note 308.

As for cy pres, there is no guarantee that a court would apply the doctrine, and good reason to think that it would not. The key issue is whether donors to 9/11-specific DROs preferred (or would have preferred had they thought about it) to reclaim any balance once the victims' basic needs were met, or to let these sums be redeployed to a related charitable purpose selected or approved by a court. If the donors' sole charitable purpose was to help 9/11 victims and only them, then a resulting trust of their share of the surplus should be created in their favor.

Several factors argue against applying cy pres here. Donors had the option of contributing either to charities formed solely to help 9/11 victims (what I have been calling 9/11-specific DROs or charities) or to general DROs that engaged in 9/11 relief as part of a wider menu of activities. Almost no 9/11-specific charity publicly discussed the possibility of raising too much money or announced a plan for disposing of any surplus. This suggests that those who gave to 9/11-specific charities *knew precisely whom* they wanted to help. Also arguing against cy pres is the fact that most gifts were donated either after or shortly before the advent of surplus. When a charity's purpose fails many years after it was founded ("supervening" failure), courts will more readily infer a "general charitable intent" than when the trust fails at or soon after the outset ("initial failure"). In cases of supervening failure, says the Second Restatement:

> The court can fairly infer an expectation on the part of the settlor that in course of time circumstances might so change that the particular purpose could no longer be carried out, and that in such a case the settlor would prefer a modification of his scheme rather than that the charitable trust should fail and the property be distributed among his heirs who might be very numerous and only remotely related to him.[311]

This presumption does not apply as strongly, if at all, to those who gave to 9/11-specific charities that "failed" soon after their creation, insofar as they raised legally-excessive funds. Most such donors likely expected the charities to wrap up their work quickly and simply did not expect their gifts to be used for anything else. Lastly, because most donors to 9/11 charities are still alive, they have an option unavailable to donors whose gifts fail or yield a surplus after they die: to personally decide with full information how to spend any dollars returned to them, including the ability to spend on their personal consumption. The typical 9/11 donor would thus find the alternative to cy pres—a resulting trust in her favor—far more attractive than the deceased settlor.

How might the surplus predicament have been prevented? Hindsight is of course 20-20. In the immediate aftermath of the attacks, many people overestimated the number of fatalities, the attack's harm to the economy, and the imminence of additional attacks. It was also not known how much assistance the government would provide. The donors' desire to give generously under these circumstances is understandable. In accepting these donations, however, the managers of 501(c)(3) charities were obliged to consider the possibility of

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311. RESTATEMENT (SECOND) OF TRUSTS § 399 cmt. i (1959).

surplus.[312] To avoid any misunderstanding, DROs can advise donors about the legal parameters on distributing aid, and the rules for disposing of surplus.[313] Armed with such information, donors can declare up front what should happen to any surplus—thereby reducing the likelihood of many headaches at the back end.

When the surpluses occurred, 9/11-specific charities could done one of two things: (1) advise would-be donors that any additional donations would be used for other (i.e., non-9/11) charitable purposes;[314] or (2) flatly refuse to accept additional donations. No charity seems to have tried the first option. The September 11th Fund was the earliest and most prominent agency to take the second route. On January 16, 2002, it announced that it was no longer accepting donations; at that point, it had already collected $425 million.[315] The Fund's managers, it was explained, "believe that current resources, when combined with those of the American Red Cross or other charities and of local, state and federal government, are appropriate to accomplish its goals."[316] Would-be donors were asked to redirect their contributions to other charities and causes.[317] This approach had the advantage of possibly saving the Fund the time, expense, and animosity of instituting a cy pres proceeding to achieve the same result.

It was not enough to simply stop soliciting potential donors for contributions, or even to ask people and institutions to stop contributing. The Red Cross pursued this first route with little success. On October 30, 2001, the agency announced that it was ceasing active solicitation" of funds for its 9/11-related

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312. In order to qualify for 501(c)(3) status, an organization must have a plan for distributing its assets to another charity or public agency for an exempt purpose. 26 C.F.R. § 1.501(c)(3)-1(b)(4); CPE 1999 at 226 (disaster-specific DROs "should have a plan for distribution of excess funds at the termination of the organization's existence in a manner consistent with the dissolution requirements under IRC 501(c)(3)").

313. As a model, they could have used the Penlee Lifeboat Disaster Fund's second press release, which advised donors that "the amount of income which the trustees could legally distribute to the bereaved was limited to their reasonable needs and that any surplus income would have to be applied for other charitable purposes." Picarda, *supra* note 202, at 35.

314. In their second press release, the Penlee Lifeboat Disaster Fund's trustees stated that they were "willing and able to continue to receive donations but stressed that, although these donations would be used for related charitable purposes, the law of charitable trusts 'does not permit an unlimited distribution to the dependents of the lifeboatmen who were lost.'" *Id.*

315. The Fund has continued to accept royalties from sales of *America: A Tribute to Heroes*, a CD featuring songs from the eponymous telethon broadcast on September 21, 2001, and contributions from fundraisers approved prior to January 16, 2002. Telephone Interview with Cristina Slattery, Program and Communications Associate, September 11th Fund (Oct. 22, 2002). One year later, the telethon and associated royalties had raised $128 million. THE SEPTEMBER 11TH FUND: ONE YEAR LATER, *at* http://www.september11fund.org/one_year_report.pdf.

316. Press Release, September 11th Fund, Americans Asked to Stop Sending Donations to the September 11th Fund (Jan. 16, 2002), *at* http://www.september11fund.org (last visited Feb. 12, 2003).

317. *Id.*

Liberty Fund.[318] At that point, it had already raised $547 million in pledges.[319] Over the next ten months, however, the Liberty Fund received at least another $453 million. The Red Cross is currently pursuing the second route: it still accepts donations specifically for 9/11 relief, but only after attempting and failing to dissuade the donor from restricting his gift for that purpose only.[320]

Some 9/11-specific DROs actively sought additional gifts throughout. As of November 9, 2001, for example, the Twin Towers Fund had raised $85 million—approximately $194,000 for each fallen rescuer's family.[321] If the managers knew that sufficient funds had been raised to meet the organization's charitable goals, then they should also have known that the surplus gifts could not be distributed to the families.[322] Assuming cy pres did not apply, these gifts would have to be fully refunded to the donors.[323] By continuing to solicit and accept gifts under these circumstances, the managers were potentially wasting people's time.

Had the IRS policy not changed, the Twin Towers Fund and similarly-situated entities might have forfeited their 501(c)(3) exempt status and lost their donors a charitable deduction. Yet change it did. The sums donated for 9/11 relief were so massive that public authorities felt compelled to unhinge the parameters of charity law in order to let them pass through.

III. MUST WE GIVE IT ALL, AND WHY?: THE PREDICAMENT OF OVERSUBSCRIBED GENERAL CHARITIES ENGAGED IN 9/11 RELIEF

The majority of money donated after 9/11 did not go to new organizations formed solely to assist victims of the attacks. It went instead to pre-existing multi-purpose charities that provided 9/11 relief as part of a range of activities, a.k.a. "general DROs." Such entities included the American Red Cross and two "widows' and children's funds" for the families of uniformed personnel killed in the line of duty. This section examines the controversies that arose over how these three agencies handled contributions. As a foil, it looks at the hassle-free experience of the New York City Police Foundation, which collected funds for the 9/11 police officers' families.

The three agencies' experiences follow a similar pattern up to a point. Like

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318. Press Release, American Red Cross, American Red Cross Names Harold Decker Interim CEO: Active Solicitation for Liberty Fund to End This Week; Board Affirms Magen David Adom Policy (Oct. 30, 2001) [hereinafter American Red Cross, American Red Cross Names Decker], *available at* www.redcross.org/press/other/ot_pr/011030decker.html.

319. *Id.*

320. Telephone Interview with Phil Zepeda, Senior Director, Media Relations, American Red Cross National Headquarters (July 16, 2002).

321. Henriques & Barstow, *supra* note 236. The Twin Towers Fund would ultimately aid 438 families. Press Release, Twin Towers Fund, Fund's Support of the Uniformed Heroes Now Tops $193 Million (Dec. 20, 2002), *available at* http://www.twintowersfund.org/news_1220_02.html.

322. Recall that this was before the IRS changed its policy and Congress changed the law.

323. RESTATEMENT (SECOND) OF TRUSTS § 432 cmt. d (1959).

many 9/11-specific charities, they were criticized for disbursing money too slowly. Yet, the allegations against them went beyond sloth or incompetence; it included deception, disloyalty, and bad faith. When the agencies proposed to use some post-9/11 donations to help victims of other calamities (and sometimes for other purposes), critics accused them of misleading donors and misusing gifts. In each case, the agency was motivated in whole or in part by an organizational commitment to treat the victims of different calamities even-handedly.

As shown below, the legal cases that these charities misled donors or thwarted their intent is less than airtight; none of these agencies unequivocally promised to use everything raised after the attacks for 9/11 relief, and most donors did not expressly restrict their gifts for that purpose. What is more clear, by contrast, is that some of these charities' gifts to 9/11 victims violated the state common law prohibition against private benefit. Interestingly, each charity's conduct inspired a different amount of criticism, and each charity responded to its critics in a different way. After discussing each case, I consider some reasons for these variations.

A. The American Red Cross and the Liberty Fund

The American Red Cross ("ARC") is the nation's oldest and foremost disaster relief organization. It responds to almost 64,000 incidents a year; some are large scale, high-profile disasters, but most are residential fires.[324] The charitable response to September 11 reconfirmed the Red Cross' preeminent role in disaster relief. A plurality of Americans—around 40%—used the agency "to channel their compassion" for victims of 9/11.[325] It raised more money than any other charity engaged in 9/11 relief—over $1 billion, as compared to the $1.4 billion collectively raised by the next thirty-three largest charities.[326] The Red Cross also endured the harshest censure for its handling of donated dollars, and suffered the most serious loss in public confidence.[327]

The agency's troubles stemmed from its decision to create a separate, stand-

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324. Volunteer Services, *at* http://www.redcross.org/services/volunteer/ (last visited Sept. 12, 2002).

325. Harold Decker, Some Straight Talk about Nonprofit Accountability: Talk at the June 20th, 2002 Charities Review Council Annual Forum, *available at* http://www.crcmn.org/donorinfo/deckerspeech.htm (last visited Oct. 15, 2002).

326. MSNBC.com, *An Instinctive Outpouring*, http://www.msnbc.com/news/806336.asp (Sept. 10, 2002).

327. In a survey of 1005 national adults conducted from April 5 to April 7, 2002, 23% of respondents said that news stories about "leaders of charities like the Red Cross mishandling donations after September 11" was one of the top one or two stories that "most undermined [their] confidence in the institution involved." This compares to 38% who were disillusioned by stories about "religious leaders like those in the Catholic Church who did not dismiss priests who abused children," and 33% by "leaders of corporations like Enron representing earnings to boost their stock prices." Hart & Teeter Research Cos., sponsored by NBC News & Wall Street Journal (Apr. 16, 2002) (available on LexisNexis).

alone fund for the donations received after 9/11, instead of depositing these into the unrestricted general fund it uses to finance all other disaster relief operations. Although created a week or so after the attacks, this new and separate fund was organized to do more than simply aid 9/11 victims; it was also supposed to help the agency prepare for and respond to future terrorist attacks. Unfortunately for the agency, information about the Fund's broader purposes was not widely publicized or reported until a month or so after September 11, 2001. By then, many people—including donors, victims, pundits, politicians and members of the public—had assumed that the fund was exclusively for 9/11 relief. The Red Cross ultimately bowed to pressure to use the fund only for that purpose, although this meant compromising its commitment to inter-disaster equity and resulted in some gifts that likely constituted private benefit under state common law principles. To avoid similar incidents in the future, the agency has implemented a new program designed to educate donors and clarify their intentions.

1. The Organization's Mandate and Pre-9/11 Practices.—The Red Cross was founded in 1881 by Clara Barton (1821-1912), a free-lance nurse who organized battlefield relief during the Civil War.[328] In 1905, Congress officially tasked it with "carry[ing] out a system of national . . . relief in time of peace, and . . . apply[ing] that system in mitigating the suffering caused by pestilence, famine, fire, floods, and other great national calamities."[329] The agency also maintains a blood bank, which provides half of the nation's blood supply and facilitates communication between members of the U.S. Armed Forces and their families, among other activities.

The Red Cross allocates disaster relief according to need,[330] a distributive principle which dictates that "needed goods" are "distributed to needy people in proportion to their neediness"[331] The agency also aims to respond to different disasters "in a uniform fashion using nationwide standards."[332] Stated differently, it seeks to help similarly distressed victims of different calamities in an even-handed manner.[333] This approach recalls Ronald Dworkin's account of

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328. ROBERT H. BREMNER, AMERICAN PHILANTHROPY 78 (Daniel J. Boorstin ed., The Univ. of Chicago Press 1966) (1960). For its first twenty-four years, the entity was a wholly private organization. *Id.*

329. 36 U.S.C. §§ 300101, 300102 (2000).

330. Victims v. Funds, 715 F. Supp. 178, 180-181 (W.D. Tex. 1989) (American Red Cross' "services are provided according to need").

331. MICHAEL WALZER, SPHERES OF JUSTICE 26 (1983).

332. Business Wire, *Red Cross Targets Additional $4.3 Million for Ongoing Flood Relief*, (June 9, 1998).

333. *See, e.g.*, Greenwood hearing, *supra* note at 2, at 51 (testimony of Dr. Bernadine Healy) ("if we did it for one person [i.e., provide grants to 9/11 families to pay for immediate and short term expenses], we would do it for everybody"); Telephone Interview with Nancy Rutherford, American Red Cross Disaster Relief Associate for Communications and Marketing for Domestic and International Disasters (Mar. 27, 2002) ("If two people were in the exact same family situation and had exactly the same disaster-related needs, then we'd provide the same amount of assistance

equality as a political ideal, which entails treating all citizens with equal concern and respect.[334] Felicitously, Professor Dworkin uses disaster relief to illustrate how the ideal applies in practice:

> Sometimes treating people equally is the only way to treat them as equals; but sometimes not. Suppose a limited amount of emergency relief is available for two equally populous areas injured by floods; treating the citizens of both areas as equals requires giving aid to the more seriously devastated area rather than splitting the available funds equally.[335]

The Red Cross finances its relief activities primarily through private fundraising as opposed to government grants. Local chapters are responsible for raising funds to respond to the smaller events that occur in their areas.[336] For large-scale national catastrophes, the Red Cross maintains a multi-Disaster Relief Fund.[337] This Fund operates on a revolving basis: contributions inspired by past disasters help pay for future relief operations.[338] This arrangement enables allows the Red Cross to respond immediately to disasters as they arise, without awaiting a new influx of donations for that particular event. On September 11, 2001, for example, the agency had approximately $50 million on hand to finance operations.[339]

The Disaster Relief Fund also permits the Red Cross to honor its commitment to inter-disaster equity. "[T]he springs of charity feeding public appeals," it has been observed, "gush or slacken in ways that are little related to the comparative needs of the recipients . . . ."[340] In the Penlee shipwreck, for example, over £3.5 million was raised for the families of the eight lost lifeboatmen, while apparently nothing was collected for survivors of the eight lost crewmen lifeboatmen were attempting to save. "Most disasters are small and don't garner the kind of attention that prompts people to contribute," a Red Cross official recently declared. "*But we believe strongly that to base the scope of our service in any particular disaster to the amount of money raised for that*

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to each.").

334. RONALD DWORKIN, A MATTER OF PRINCIPLE 190-91 (Harvard Univ. Press 1985).

335. *Id.* at 190.

336. Letter from Harold J. Decker, American Red Cross Interim Chief Executive Officer, to Senator Charles Grassley 32 (June 14, 2002) [hereinafter Decker Letter], *available at* http://www.redcross.org/press/disaster/ds_pr/020614grassleyresponse.html.

337. *Id.*

338. *See generally* Deborah Sontag, *Who Brought Bernadine Healy Down?*, N.Y. TIMES MAGAZINE, Dec. 23, 2001, at 76; Greenwood hearing, *supra* note 2, at 32 (statement of Dr. Bernadine Healy) ("if we have money left over from one hurricane . . . we leave it [in the Fund] and we use it for the next hurricane.").

339. Greenwood hearing, *supra* note 2, at 33 (testimony of Dr. Bernadine Healy).

340. Editorial, TIMES (London) (Aug. 6, 1982), *reprinted* in SUDDARDS, *supra* note 202, at 33.

disaster is fundamentally unfair. You could say it's un-American."[341] Because the Fund's monies are typically unrestricted, they may be allocated among calamities according to the victims' relative need, rather than public sympathy or other factors the agency deems irrelevant. To this end, the Red Cross "uses the high-profile disasters to beef up general [i.e., unrestricted] disaster-relief funds."[342] This generates surpluses to spend on lower-profile incidents, such as "the little old lady in Philadelphia who loses her home to fire."[343] This strategy is not a secret; in the past when the Red Cross has solicited for the fund following a major catastrophe, it advised would-be donors that gifts would be used "for this disaster and *similar disasters*."[344]

Although the Red Cross permits donors to restrict their disaster relief gifts to particular calamities, it discourages them from doing so.[345] Even so, the Red Cross can usually honor the terms of disaster-specific gifts *and* respond to different disasters in a uniform way. The sum of gifts restricted to a particular disaster is ordinarily less than what the Red Cross would have spent in the absence of such restrictions. Due to the "fungibility of money," the agency's use of restricted gifts for their earmarked purpose "simply free[s] the organization to use an equivalent amount of its own funds for other purposes."[346] On a few occasions before 9/11, however, disaster-specific donations exceeded what agency officials believed was needed to respond to that specific disaster.

After major floods struck Minnesota and North Dakota in the Spring of 1997, the Red Cross collected over $16 million in donations specifically designated for the floods' victims. After spending more than $11.7 million on disaster relief, the agency determined that it had "met all known disaster-caused needs in accordance with its disaster relief policies."[347] The agency then began receiving inquiries and criticism from Minnesota's attorney general and others about the other $4.3 million in designated funds. The Red Cross ultimately announced a plan to provide additional "*non-emergency* assistance" to address flood victims' other disaster-related needs, and "to help the region prepare for the next time flood waters threaten lives and property in the area."[348] This included disbursements to help individuals and families pay for disaster-related moving costs, flood insurance, and household debts accumulated due to flood-related

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341. Decker, *supra* note 325 (emphasis in original).

342. Sontag, *supra* note 338.

343. *Id.*

344. Greenwood hearing, *supra* note 2, at 43.

345. Decker, *supra* note 325.

346. Atkinson, *supra* note 8, at 584.

347. Press Release, American Red Cross, Red Cross Targets an Additional $4.3 Million for Ongoing Flood Relief 1 (June 9, 1998) [hereinafter American Red Cross, Additional $4.3 million] (on file with author); Press Release, American Red Cross, Plan for Application of Remaining Designated Funds, 1997 DR-344 and DR-345, Minnesota and Red River Valley Floods 1 (June 5, 1998) [hereinafter American Red Cross, Plan for Application] (on file with author).

348. American Red Cross, Additional $4.3 million, *supra* note 347, at 1 (emphasis added).

unemployment.[349]

Critically, the Red Cross did *not* commit to distributing the $4.3 million among the flood victims on any basis other than need, nor did it commit to spending the entire balance on this particular flood. Rather, the agency promised to pursue its post-disaster plan until its goals were achieved or the money ran out, whichever came first.[350] If these goals were achieved without spending the entire $4.3 million, then the balance would be used to respond to future disasters in the area.[351] The agency thus never relinquished the authority to declare a surplus and to redeploy it as it thought best.

2. Liberty Fund: The Concept.—Immediately following the 9/11 attacks, the Red Cross did what it usually does: it mobilized staff, volunteers and resources to provide "emergency mass care and assistance for individuals with urgent and verified disaster-caused needs."[352] This included providing emergency food, shelter, amenities and counseling to three classes of persons: the families of the dead or missing; people made homeless or stranded by the attacks; and the rescue and recovery workers.[353] Americans, too, responded in a familiar fashion—by contributing money—albeit in unprecedented amounts.

On the day of the attacks, the Red Cross received the largest number of online donations in its history—nearly one per second, bringing in over $1 million in twelve hours.[354] Most people who contributed at this time likely did so based on what they already knew about the Red Cross and its activities, rather than in response to a direct solicitation from the agency.[355] Had they examined the various appeals, however, they would have heard inconsistent messages. Some of the Red Cross' messages contained the standard formulation: donate to the general Disaster Relief Fund in order "to help those affected by this and *other disasters*."[356] Other communications, however, appeared to solicit funds solely

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349. American Red Cross, Plan for Application, *supra* note 347, at 2.

350. *Id.* at 3.

351. *Id.* at 2, 3.

352. *Id.* (quoting *Board of Governors Policy Manual*, Part One, Section 2.6.3).

353. *See* American Red Cross, September 11, 2001: Unprecedented Events, Unprecedented Response—A Review of the American Red Cross' Response in the Past Year 4 (Sept. 11, 2002) [hereinafter American Red Cross, Unprecedented Events], http://www.redcross.org/press/disaster/ds_pr/pdfs/arcwhitepaper.pdf (last visited Mar. 4, 2003).

354. News Release, American Red Cross, American Public Joins the Red Cross in Unprecedented Relief Efforts Around the Country, http://www.redcross.org/press/disaster/ ds_pr/010912relief.html (last visited Sept. 16, 2002) [hereinafter American Red Cross, American Public Joins].

355. *See* Bjorklund, *supra* note 9, at 31; American Red Cross, Unprecedented Events, *supra* note 353, at 4 (On September 11, 2001, "The Red Cross begins taking *spontaneous* donations to help the victims of the attacks and their families.") (emphasis added).

356. American Red Cross in Greater New York, American Red Cross Expresses Profound Gratitude as Nearly 7000 Volunteer Time and Resources (Sept. 15, 2001) (emphasis added); *see also* American Red Cross in Greater New York, New York Red Cross Plans Day Three of Ongoing Response To World Trade Center Tragedy (Sept. 13, 2001) ("[t]o help with this [9/11] and other

for terrorism-related relief. A press release on the national Red Cross' website, for example, invited contributions "[t]o help provide support for people in need following *this* disaster as well as emerging human needs resulting from *this* tragedy."[357]

The agency clarified its post-9/11 goals on September 20, 2001, when Dr. Bernadine Healy, then Red Cross President and CEO,[358] sent a memorandum to all Red Cross units and chapters.[359] An abridged version of this memo was posted the same day on the agency's national website.[360] These communications announced the creation of a new fund called the "Liberty Disaster Fund" (a.k.a. "Liberty Fund"), that would be separate and segregated from the Disaster Relief Fund. The Liberty Fund, the memo explained, "will support the immediate and emerging efforts of the American Red Cross to alleviate human suffering brought on by the attacks of September 11."[361] Viewed in isolation, this one-sentence synopsis is ambiguous: Would Liberty Fund dollars be used solely for distress caused by these specific attacks, including distress that had yet to appear or be apprehended? Or did the term "emerging efforts" point to something broader? The rest of the memo clarifies the matter by revealing a broader set of purposes: "the Liberty Fund will support an integrated response that involves virtually all of our lines of service," including responding to attacks involving weapons of mass destruction, collecting more blood and preserving it for longer periods (a.k.a. "strategic blood reserve"), promoting public awareness of the Red Cross' principles (a.k.a. "community outreach"), and expanding services to members of the armed forces.

The Liberty Fund would serve as the Red Cross' bank account for gifts

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disasters. . . .") (emphasis added); Better Business Bureau, Wise Giving Alliance report on the American Red Cross (Aug. 2002), *at* http://www.give.org/reports/arc.asp [Better Business Bureau report] (the Red Cross' 1-800 number script and the language used on its online donation site shortly after 9/11 reflected the agency's intent to use donations for other activities as well as for 9/11 relief).

357. American Red Cross, American Public Joins, *supra* note 354 (emphasis added); News Release, American Red Cross, How Americans Can Best Help Red Cross Relief Efforts, *at* http://www.redcross.org/press/disaster/ds_pr/010918how2help.html (last visited Sept. 16, 2002) [hereinafter American Red Cross, How Americans Can Best Help] (emphasis added); *see also* Better Business Bureau report, *supra* note 356 (quoting two public service announcements (PSAs) the Red Cross used to solicit donations after 9/11 that focused on the agency's 9/11 activities and did not mention of a broader use of such donations).

358. Dr. Healy resigned on October 26, 2001.

359. Memorandum from Dr. Bernadine Healy, to The American Red Cross Family (Sept. 20, 2001) [hereinafter Healy Memo] (on file with author). Dr. Healy created the Liberty Fund without the prior formal approval of the Red Cross' board, but the board later ratified this decision. Greenwood hearing, *supra* note 2, at 33-39 (testimony of Dr. Bernadine Healy).

360. Press Release, American Red Cross, Preserving America's Spirit: The Liberty Disaster Fund, *at* http://www.redcross.org/news/ds/0109wtc/libertyfund.html (last visited Sept. 20, 2002) [hereinafter American Red Cross, Preserving America's Spirit].

361. Healy Memo, *supra* note 359.

received on or after September 11, 2001, including gifts not expressly designated for "the Liberty Fund," "disaster relief," or "9/11 relief." More specifically, all unsolicited contributions made payable simply to "The American Red Cross" from September 11 through September 30, 2001, were placed in the Liberty Fund.[362] All gifts for generic disaster relief received between September 11, 2001 and October 31, 2001 were also placed in that account.[363]

Dr. Bernadine Healy's September 20 memo rejected concerns that the Liberty Fund might raise too much money for 9/11 relief (i.e., produce a "surplus" according to the agency's uniform standards), and that the agency would be unable to use this surplus for other purposes. These fears were unwarranted, the memo replied, because the Liberty Fund was organized for more than just 9/11 relief and thus not restricted to that event.

> This is not a "regional" disaster; it is not only about the hideous events that occurred in New York City, Pennsylvania and Pentagon. Rather this is a disaster that affects *our entire nation*, at this time and *as we look ahead* . . . .
>
> Some have suggested that we might raise more than we need to respond to this attack on America's spirit, liberty, and national security and that contributions should be placed in our general disaster fund. I can assure you that we will only raise more money than we need if we do less than we should.[364]

When she created the Liberty Fund, Dr. Bernadine Healy believed that future terrorist attacks against Americans were imminent,[365] and that the United States Government was mobilizing for military action.[366] She was summoning the agency to shift into war mode,[367] and to do so on a scale "not seen since the world wars."[368] In this respect, the Liberty Fund was a "war fund."[369] Its monies were "restricted" in the sense that they would only be used to support agency activities

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362. Better Business Bureau report, *supra* note 356.

363. American Red Cross Donor Contributions Coding Guidance (Oct. 1, 2001) (on file with author). After October 31, 2001, the Red Cross stopped depositing gifts for generic disaster relief in the Liberty Fund; thereafter, such gifts were deposited in the general Disaster Relief Fund. *Id.*

364. Healy Memo, *supra* note 359 (emphasis added).

365. Greenwood hearings, *supra* note 2, at 55; *see also* American Red Cross, Unprecedented Events, *supra* note 353, at 6 (chronology entry for Oct. 12, 2001)

366. Greenwood hearings, *supra* note 2, at 55; American Red Cross, Preserving America's Spirit, *supra* note 360 ("our work under the Liberty Disaster Fund will [also] be about our Armed Forces Emergency Services efforts on behalf of families and service men and women in the context of military activation and response. We may also be facing possible wartime casualties, and we must have a Red Cross in full support of our military everywhere and in support of our obligations as an auxiliary to the U.S. government under the Geneva Conventions.").

367. *Id.* at 28.

368. *Id.* at 24.

369. *Id.* at 28 (testimony of Dr. Bernadine Healy).

related to preparing and responding to anti-U.S. terrorist attacks and U.S. military action. The Red Cross retained discretion to allocate the funds among this broad set of activities as it saw fit.[370] This understanding is consistent with the agency's use of Liberty Fund dollars to assist anthrax victims, who were also understood as casualties in the new era of terrorism.[371]

Notwithstanding the Liberty Fund's broader mandate, the agency initially channeled the incoming funds towards immediate needs.[372] The agency was providing shelter, food, goods and social services either in-kind or through vouchers—its traditional relief activities. In addition, it began making large cash gifts to the seriously injured and to families that lost a breadwinner. This program, called the "Emergency Family Gift Program," was designed to help recipients pay for three months' worth of living expenses.[373] Payments were determined on the basis of family size, rent or mortgage, and other cash flow needs such as tuition, credit card payments, and funeral expenses not otherwise covered.[374] This program was a major departure for the Red Cross. "Normally," Dr. Healy explained, "in a hurricane or another typical natural disaster, people's homes get destroyed but their economic well-being is breadwinners. Here their homes are fine, but they lost their breadwinner."[375]

Although Dr. Healy's announcement of September 20, 2001, pointed to the Liberty Fund's broader purposes, the Red Cross seems to have done relatively little at first to publicize these, and they went virtually unnoticed by the media.[376]

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370. *Id.* at 40-41 (testimony of Dr. Bernadine Healy) (with the general disaster relief fund, "if we have money left over from one hurricane, like Hurricane Floyd, we leave it in that fund and we use it for the next hurricane .... So, in a way this [the Liberty Fund] is similar thing, except we're limiting it to this extraordinary situation, which is a new kind of war.").

371. *Id.* at 28 (testimony of Dr. Bernadine Healy). Others shared this same perception, including Congress. The Victims of Terrorism Tax Relief Act of 2001 authorized charities to make non-need based payments related to both the 9/11 attacks and attacks involving anthrax occurring on or after September 11, 2001, and before January 1, 2002. Pub. L. No. 107-134, 115 Stat. 2427 (codified as 26 U.S.C. § 501).

372. *Id.* at 31-32 (testimony of Dr. Bernadine Healy) ("There is no question that the immediate response in the highest priority, as it always is, of the American Red Cross is to move in very quickly to assist those in need at ground zero. And we had three ground zeros, in New York, in Pennsylvania and at the [P]entagon.").

373. Yung Kim, *Red Cross Will Aid Families of Victims; American and the World*, THE RECORD (Bergen County, N.J.), Sept. 25, 2001, at A13; Greenwood hearing, *supra* note 2, at 51 (remarks of Dr. Bernadine Healy); Press Release, American Red Cross, Red Cross Estimates $300 Million Required to Meet Immediate, Near-Term Needs Following September 11th Tragedy (Oct. 12, 2001) [hereinafter American Red Cross, Red Cross Estimates], *at* http://www.redcross.org/press/disaster/ds_pr/011011nearterm.html.

374. Greenwood hearing, *supra* note 2, at 51 (remarks of Dr. Bernadine Healy);

375. *Id.*

376. A Lexis search of major newspapers in the two weeks after September 20 reveals only a dozen or so articles making substantive references to the Liberty Fund, most of which imply that the Fund would be used solely for 9/11 relief. *See, e.g.*, Elisa Ung & Patrick May, *As Aid Pours*

The agency also continued to use at least two public service announcements (PSAs) that focused solely on its 9/11 activities.[377] On October 12, 2001, the Red Cross announced more detailed plans for spending Liberty Fund monies. This announcement included the first significant reiteration of the fund's broader purposes since September 20, 2001.[378] As of October 12, the Liberty Fund contained $375 million in donations or pledges. Of this, the agency proposed to spend around $211 million on direct aid to victims and their families.[379] The balance of the Liberty Fund was apparently deemed surplus with respect to 9/11 relief. Recalling the principle of inter-disaster equity, the $211 million figure was later said to "reflect . . . a range of activities that is similar, though larger in scale, to what [the agency] normally does in response to disasters."[380] Also on October 12, the agency announced its plans to spend funds on various programs

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in, Charities Struggle with Distribution, HOUSTON CHRON., Sept. 27, 2001, at A4 ("the American Red Cross has set up the so-called Liberty Fund to hold the $202 million in donations it has received since Sept. 11. The money in the Liberty Fund will be used strictly for immediate and future needs relating to the attacks, said spokeswoman Amanda Land."); Jon Yates, *Look Before Leaping to Give, Experts Say*, CHI. TRIB., Oct. 5, 2001, at 1 ("Red Cross officials have committed to spending all of the money they have received since Sept. 11—$277 million through Wednesday—on efforts specifically related to the terrorist attacks."); Amy Sacks, *Donations Haven't Tapered Off*, N.Y. DAILY NEWS, Oct. 3, 2001, at 26 (Liberty Fund donor says "I feel wonderful to be given the opportunity to support the relief effort"); Bob LaMendola, *Check Them Out Before You Give*, SUN-SENTINEL (Fort Lauderdale, Fla.), Sept. 22, 2001, at 7A (reporting that the Red Cross was putting all the money donated since 9/11 "into a separate account, the Liberty Fund, to assure the public that none of the money is going to everyday work"; donors "can feel pretty safe about giving money to" the Red Cross "for the families of terrorist victims"). I performed this search in the "Major Newspapers" database, using the terms "liberty fund" or "liberty disaster relief fund" and "red cross" and date(geq (9/11/2001) and leq (10/5/2001)) .

377. *See* Better Business Bureau report, *supra* note 356 (in use from Sept. 12, 2001, until the week of Oct. 1, 2001) ("Shocking tragedies have occurred and America is in mourning. A long period of uncertainty and recovery awaits us all. The American Red Cross is providing lifesaving assistance including precious blood, food, shelter, and grief counseling. We honor our heroic relief workers, victims and their families. Please call 1-800 . . . to donate blood, or 1-800 . . . to offer financial support. Together, we can save a life."); Red Cross PSA script (in use from Sept. 12, 2001, through Oct. 29, 2001) ("In this time of need, the American Red Cross is profoundly grateful for your generous outpouring of support. A long period of uncertainty and recovery awaits us all. Thanks to your contributions, the American Red Cross is providing lifesaving assistance including food, shelter, grief counseling, and precious blood. We still need your help. Please call 1-800 . . . to offer your financial support for this tragedy and its emerging needs. Together we can save a life.").

378. American Red Cross, Red Cross Estimates, *supra* note 373.

379. This consisted of around $100 million for traditional relief activities, $100 million for the Emergency Family Gift Program, and $11 million to repatriate the remains of foreign nationals, help their families travel to the United States, and similar needs. *Id.*

380. American Red Cross, American Red Cross Names Decker, *supra* note 318.

geared towards future terrorist attacks which seemed imminent at the time.[381] These included blood inventory (the "strategic blood reserve") ($50 million), relief infrastructure ($29 million), community outreach ($16-26 million), and services to members of the Armed Forces.[382] The remaining $55 million to $65 million would be held in reserve. The Red Cross, the announcement explained, "also has the responsibility to invest additional resources in preparedness and mitigation for present and future terrorist threats in the aftermath of what took place on September 11th."[383] It referred to these unspecified longer-term plans as a "phase II effort under the" Liberty Fund.[384]

On October 30, the Red Cross announced that it was "end[ing] the active solicitation of funds" for the Liberty Fund.[385] At that point, the Liberty Fund contained $547 million in donations and pledges. This sum, the agency had determined, was "sufficient to address immediate, near-term and long-range needs relating to the September 11 tragedies as well as necessary public education and terrorism preparedness actions."[386] From that point on, any gift for generic disaster relief would once again be deposited in the General Disaster Relief Fund, unless the donor expressly designated it for a more specific use. Since the October 12th announcement, the sums available for the Liberty Fund's "phase II effort" had grown from $55-65 million to $227 million. At least some of this reserve would be used "to help people affected by . . . other terrorist events that could occur in the near future."[387] The availability of such reserves would enable the agency to honor its equity norm by providing the victims of future terrorist attacks with the same range of benefits as 9/11 victims.[388] The

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381. American Red Cross, Unprecedented Events, *supra* note 353, at 6 (chronology entry for Oct. 12, 2001).

382. Relief infrastructure included "telecommunications such as the toll-free nationwide hotlines now being operated by the Red Cross to provide immediate help to callers, information systems, database management, contribution processing, public information and communication, expanded audit services, accounting services and around-the-clock activation of the Red Cross Disaster Operations Center." American Red Cross, Red Cross Estimates, *supra* note 373. Outreach entailed "services in communities across the country will be expanded to include promoting humanitarian principles such as neutrality and unity and encouraging tolerance; providing grieving and healing outreach programs; and expanding international humanitarian law efforts." *Id.*

383. *Id.*

384. *Id.*

385. American Red Cross, American Red Cross Names Decker, *supra* note 318.

386. *Id.*

387. *Red Cross Testimony at W&M Hearing on Charitable Groups' Reaction to Terrorist Attacks*, 34 EXEMPT. ORG. TAX. REV. 462, 463 (written statement of Michael Farley, Vice President, Chapter Fundraising to the U.S. House of Representatives, Committee on Ways and Means, Subcommittee on Oversight, held on Nov. 8, 2001).

388. Greenwood hearing, *supra* note 2, at 41 (testimony of Dr. Bernadine Healy) ("if there were another disaster tomorrow, and we have reserves in the Liberty Fund, we would offer the very same services, the same cash grant programs, the same mental and spiritual counseling, the same social services that we have offered in new Jersey, in Pennsylvania, in New York and at the

size of the reserve, an agency spokesman said, "depends on how much money we wind up with."[389]

3. Liberty Fund: The Controversy.—As public awareness of the Liberty Fund's broader mandate grew, so did public criticism. The agency began receiving hundreds of calls from upset donors demanding their money back.[390] TV commentator Bill O'Reilly captured the sentiment of many when he declaimed that:

> after collecting more than $550 million from generous Americans, the Red Cross now says that some of that money will not go to the families of the terror victims *even though the donated money was given specifically for that purpose*. The Red Cross apparently believes it has the right to do other things with your donations.[391]

The controversy peaked the week of November 4, 2001, when New York State Attorney General Eliot L. Spitzer threatened to sue the Red Cross for fraud and breach of donor intent unless it spent the entire Liberty Fund on 9/11 victims.[392] That same week, two congressional subcommittees held hostile hearings to investigate the Red Cross' handling of post-9/11 contributions.[393] Whereas Mr. Spitzer alleged that the agency had broken the law, members of Congress complained that the Red Cross had acted unethically and in bad faith. They asserted that the agency was morally obliged to do what its donors actually intended or expected, regardless of whether they communicated their preferences to the agency. As one congressman told Dr. Healy:

> I don't care what it says on the back of a [Red Cross solicitation] envelope or in a PSA [public service announcement] or so forth. You

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Pentagon we would offer that to this group. We'd probably—they might need to raise more money. But we would have some reserves.").

389. Todd Wallack, *Red Cross Donations Earmarked for Future; Agency May Have Enough for Terror Victims*, S.F. CHRON., Oct. 17, 2001, at A8.

390. Todd Wallack, *Red Cross Returns Some Contributions; Plan for Relief Fund Angers Several Donors*, S.F. CHRON., Nov. 2, 2001, at A1.

391. Transcript, The O'Reilly Factor (Fox News television broadcast Dec. 30, 2001) (emphasis added).

392. Douglas Turner, *Spitzer Threatens Legal Action Against Red Cross if It Fails to Disburse Funds*, BUFF. NEWS, Nov. 9, 2001, at A12; Susan Edelman, *Charity Tries Kissing Up to Cross Donors*, N.Y. POST, Nov. 11, 2001, at 3. *See* NY CLS Exec §§ 172-d(3) & -d(4) (2002).

393. On November 6, 2001, the Oversight and Investigations Subcommittee of the Energy and Commerce Committee of the House of Representatives, chaired by James Greenwood (R-PA), held a hearing entitled "Charitable Contributions for September 11: Protecting Against Fraud, Waste, and Abuse." Greenwood hearing, *supra* note 2. On November 8, 2001, the Oversight Subcommittee of the House of Representatives Ways and Means Committee held a hearing on "Charitable Organizations' Distribution of Funds Following the Recent Terrorist Attacks," 2001 WL 1400781 (F.D.C.H.) [hereinafter Houghton hearing]. I refer to this as the Houghton hearing after Subcommittee chair Amo Houghton (R-NY).

> know that if you asked Americans where they thought the money was going to the Liberty Fund, they thought it was going to the victims of the [9/11] disaster . . .[394]

Another congressman professed that "I don't believe anyone that wrote a check [to the Red Cross] expected that it would be used for frozen blood,"[395] referring to the agency's proposed strategic blood reserve. "[P]eople I know thought that the money was going to [survivors of those killed in the attacks]," reported a congresswoman. "They didn't think it was going for the telephone systems,"[396] she said, referring to the agency's proposal to upgrade its relief infrastructure. The congresswoman also declared that "*every single person* who contributed to this effort has done so with the best of intentions that these funds will go to help the victims' families of this terrible tragedy, to help the firefighters' funds, to help all of the caregivers who've helped."[397]

Despite the growing controversy, the Red Cross initially seemed prepared to follow through on its stated plans for the Liberty Fund, even after Dr. Healy's resignation on October 26, 2001. In a letter to *The New York Times* dated November 5, 2001, the agency's leaders defended its plan to reserve some funds for future attacks: the Red Cross' "humanitarian mission and responsibilities under our Congressional charter require us to help people grieve, recover and *prepare for future [terrorist] events*."[398] In the event of future attacks, said an agency official, the Red Cross "would draw on that reserve to help those victims," adding that "I don't think there's a donor in America that would object to the fact that we're holding onto this money to help people elsewhere."[399] On November 6, 2001, Dr. Healy rhetorically asked a congressional subcommittee:

> If 5,000 are harmed tomorrow, do we go out and ask for another billion dollars from the American public? OR do we carefully steward the money that is here [in the Liberty Fund] and make sure that we do have reserves, so that we can . . . as *equitably* deal with the next attack if there are large numbers of people, as we have the first.[400]

In a similar vein, an agency spokesman said that "God forbid there's a truck bombing in Albany next week. The American Red Cross has to be prepared, and

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394. Greenwood hearing, *supra* note 2, at 44 (statement of Rep. Charles F. Bass (R-NH)).

395. *Id.* at 32 (statement of Rep. Peter Deutsch (D-FL)).

396. *Id.* at 49 (statement of Rep. Diana DeGette (D-CO)).

397. *Id.* at 10 (statement of Rep. Diana DeGette (D-CO)).

398. *Red Cross and Sept. 11*, N.Y. TIMES, Nov. 6, 2001, at A20 (letter to the editor from David Mc Laughlin, chairman of the Red Cross board of governors, and Harold Decker, interim chief executive) (emphasis added).

399. Haya El Nasser, *Red Cross May Triple Aid to Victims*, USA TODAY, Nov. 6, 2001, at 2A (statement by Bill Blaul, Red Cross senior vice president).

400. Greenwood hearing, *supra* note 2, at 28 (statement of Dr. Bernadine Healy) (emphasis added). Note again the stated desire to treat the victims of different terrorist attacks in an even-handed manner.

anything less in this environment is playing a risky game."[401] Donors unhappy with the agency's handling of their gift were invited to request a refund.[402]

In the end, the Red Cross changed its original plans, which it subsequently described as "not consistent with the intent of donors."[403] On November 14, it announced that the Liberty Fund would be used exclusively to meet the immediate and long-term needs of 9/11 victims.[404] That one day turned out to be the biggest bonanza in 9/11 fundraising. At that point, the Red Cross had planned to spend only $200 million on its 9/11 relief efforts.[405] The November 14th announcement committed everything the Liberty Fund had already raised, $564 million, and everything that it would collect in the future, over $364 million, to that end. In a single day, therefore, the agency effectively expanded its 9/11 budget by 400%—from $200 million to over $1 billion.[406]

4. Preventing Future Liberty Fund Fiascos.—Following its reversal, the Red Cross faced two new challenges: finding ways to spend $800 million *more* than it had earlier deemed "sufficient to address immediate, near-term and long-range needs relating to the September 11 tragedies;[407] and taking steps to prevent such unhappy experiences from reoccurring.

To spend the additional sums, the Red Cross is expanding mental health services for the broader community and increasing cash payments to the attacks' most direct victims, i.e., the seriously injured and families, dependents and heirs of those killed. The Red Cross' additional expenditures on mental health are considerable. "No mental health program of this magnitude and with this level of coordination had been deployed before," the agency proudly reports, "and it is already being heralded as 'unprecedented' by the national media."[408] The agency's increased cash gifts are also substantial. Under its initial "Emergency Family Gift Program," the agency offered three month's financial support to affected families to for rent or mortgage, utilities, food, etc. After November 14, 2001, the covered period was extended to a year.[409] (Tellingly, the word

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401. Edelman, *supra* note 392.

402. Corey Kilgannon, *A Nation Challenged: Donations: Red Cross Offers to Refund Gifts for Sept. 11*, N.Y. TIMES, Nov. 12, 2001, at B10.

403. Letter from Harold J. Decker, American Red Cross Interim President and Chief Executive Officer, to The Honorable Charles Grassley 1 (June 14, 2002) (introducing The American Red Cross Response to Senator Charles E. Grassley's Inquiry Letter).

404. Becky Orfinger, *Red Cross Extending Aid to Those Affected by Sept. 11 Tragedies*, American Red Cross in the News (Nov. 14, 2001), *at* http://www.redcross.org/news/ds/0109wtc/011114liberty.html.

405. As noted above, it planned to spend another $100 million on the strategic blood reserve and other projects. It proposed to hold the remaining $264 million "in reserve" for future needs, including responding to future terrorist attacks.

406. The Liberty Fund raised $1.001 billion as of September 11, 2002. American Red Cross in Greater New York, *supra* note 356, at 9.

407. American Red Cross, American Red Cross Names Decker, *supra* note 318.

408. American Red Cross, Unprecedented Events, *supra* note 353, at 11.

409. *Id.* at 10.

"Emergency" was dropped from the name; it was now simply the "Family Gift Program.") The agency is also writing checks of $45,000 to the estate of every person killed and to those who were seriously injured or disabled on 9/11.[410] This is a pro rata division of assets with no means-testing.

To avoid similar incidents in the future, the Red Cross has introduced a new fundraising initiative called "Donor DIRECT," where the latter term stands for "D(onor) I(ntent) RE(cognition), C(onfirmation) and T(rust)." This program aims to reassert the centrality of the general Disaster Relief Fund and its multi-disaster function, educate donors as to how it operates, clarify the intent of each donor regarding the use of her gift, and shield the agency from pressure to spend more than it deems warranted on any particular disaster.

As part of this initiative, the Red Cross has changed its written solicitation materials to underscore its discretion to use Disaster Relief Fund monies to respond to any domestic disaster, rather than just the particular one that may have prompted or preceded the donor's decision to give. These solicitation materials used to ask potential donors to "help the victims of [this disaster] and *other disasters* by contributing to the American Red Cross Disaster Relief Fund."[411] The solicitation now states:

> [y]ou can help the victims of _____ and *thousands of other disasters across the country each year* by making a financial gift to the American Red Cross Disaster Relief Fund, which enables the Red Cross to provide food, shelter, counseling and other assistance to the those in need.[412]

Donors who make unrestricted gifts to the Disaster Relief Fund will be asked to confirm that they understand the leeway this affords the agency.[413] To avoid surplus issues, the Red Cross now estimates how much it expects to spend on each major or high-profile disaster according to its uniform national standards.[414] When it appears that contemporaneous contributions may exceed the spending target, potential donors are advised that enough money has been received for the current disaster. These persons are then encouraged to give to their local Red Cross chapter or to the Disaster Relief Fund.[415] The goal of this policy, the agency has explained, is "to avoid a situation where too much money is raised around a [specific] disaster which, in turn, creates an expectation that more money will be spent on its victims" relative to similarly situated victims of other

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410. *Id.*

411. Press Release, American Red Cross, American Red Cross: Strengthening Disaster Fund-Raising, *at* http://www.redcross.org/press/diasters/ds_pr/DIRECT.pdf (last visited Feb. 8, 2003).

412. Press Release, American Red Cross, Red Cross Announces New Disaster Fund-raising Practices (June 5, 2002), *at* http://www.redcross.org/press/disaster/ds_pr/020605dsfunds.html (emphasis added).

413. *Id.* This confirmation policy only applies to gifts received through the Red Cross' own solicitation channels.

414. *Id.*

415. *Id.*

disasters.[416]

5. Assessing the Legal Case Against the Red Cross.—In early November 2001, New York Attorney General Eliot Spitzer threatened to sue the Red Cross unless it spent the entire Liberty Fund on the victims of 9/11. Legal action was warranted, he argued, on grounds that the Red Cross had represented to donors that these funds would be used exclusively this purpose.[417] This charge is not groundless. As noted above, at least two of the agency's early, pre-Liberty Fund public service announcements (PSAs) focused exclusively on the Red Cross's 9/11 relief activities, while inviting listeners to contribute to the Disaster Relief Fund.[418] After it created the Liberty Fund, the Red Cross did relatively little at first to publicize its broader aims. On the basis of such evidence, the Better Business Bureau's (BBB) Wise Giving Alliance determined that in 2001, the Red Cross had failed to meet the BBB's standard that charitable solicitations be "accurate, truthful and not misleading, both in whole and in part."[419] More specifically, the BBB found that:

> (1) Many of the initial 9/11 relief appeals requesting financial donations omitted a material fact: the Red Cross initially intended to use some of these donations for broader purposes than stated in those appeals after, in the Red Cross' view, all 9/11 needs were met; (2) Appeals that did disclose the Red Cross' intention to spend funds on broader purposes did not do so in a clear and conspicuous manner that would be reasonably understood by potential donors given the circumstances of 9/11.[420]

Although this sounds damning, one must note that the BBB's standards for

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416. *Id.*

417. Houghton hearing, *supra* note 393, at 51 (statement of Eliot Spitzer, New York State Attorney General).

> [O]ne could argue that if [Red Cross] funds are not in fact spent for the [represented] purpose, that you have false advertising, you had a violation of consumer protection laws and a violation of certain other charitable obligations that are codified in New York State law . . . . So there is the opportunity . . . that a legal inquiry could be undertaken to try to force the Red Cross to abide by its legal obligation to spend the funds for the purposes for which they were raised and to abide by the obligations that were made in its solicitations to the American public.

See N.Y. EXEC. LAW § 172-d(3) (consol. 2002) ("no person shall . . . use . . . false or materially misleading advertising or promotional material in connection with any solicitation" and collection of funds for charitable purposes); Marcus v. Jewish Nat'l Fund, 557 N.Y.S.2d 886 (App. Div. 1990) (charities may be sued for false advertising under general business code).

418. Houghton hearing, *supra* note 393, at 55 (statement of Eliot Spitzer, New York State Attorney General) (where charity ran ads "maintaining that the funds would be used for the victims of September 11, one could argue that if funds are not in fact spent for that purpose, that you have a violation of consumer protection laws . . . .").

419. Better Business Bureau report, *supra* note 356.

420. *Id.*

charitable solicitations exceed what the law requires.[421] In its follow-up exchanges with prospective donors, the agency helped correct any misperceptions that its PSAs may have encouraged. The PSAs asked viewers to call a 1-800 telephone number to make a financial contribution.[422] The people who answered these 1-800 calls, in turn, informed callers that gifts to the Disaster Relief Fund would *"help the victims of this disaster and other disasters like it."*[423] Similarly, those who visited the agency's website were asked to "help support relief for this tragedy and other disasters" by donating to the Disaster Relief Fund.[424] When it created the Liberty Fund, the agency publicized its broader plans for these monies at the outset on its website.[425] The name itself—"Liberty Fund"—also conveyed a broader focus than 9/11: the fund was not called, for example, the "Red Cross September 11th Fund." Although the Red Cross could have communicated the Liberty Fund's broader aims more clearly, widely and sooner, it did not keep these under wraps, and they were always accessible to the attentive donor. The case for misrepresentation is thus less than compelling.[426]

In addition to misrepresentation, Mr. Spitzer accused the agency of violating its donors' intentions.[427] On one level, this charge is somewhat superfluous, as most Liberty Fund donors did not expressly restrict their gifts to 9/11 relief.[428] In such cases, the law generally equates the donors' intentions with the agency's representations. The issue of "donor intent" thus folds into the first inquiry: what

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421. For example, the BBB's standards state that a charity's fundraising costs should not exceed 35% of related contributions. Better Business Bureau, Wise Giving Alliance, Council of Better Business Bureaus' Standards for Charitable Solicitations B4(c), *at* http://www.give.org/standards/cbbbstds.asp. Yet statutes that attempt to set ceilings on fundraising expenses have been repeatedly invalidated. *See, e.g.*, Riley v. Nat'l Fed'n of the Blind of North Carolina, Inc., 487 U.S. 781 (1988) (state law prohibiting a professional fundraiser from charging an unreasonable fee and providing for a three-tiered definition of an unreasonable fee based on percentage of donations remitted to charity unconstitutionally infringes upon freedom of speech).

422. Better Business Bureau report, *supra* note 356.

423. *Id.*

424. *Id.*

425. *See* American Red Cross, Preserving America's Spirit, *supra* note 360.

426. For her part, Dr. Bernadine Healy told Congress under oath that "the American Red Cross, to my knowledge, has never described its [Liberty Fund] work as limited only to those . . . people who were lost on 9/11 and their [families] in New York and Pennsylvania and the Pentagon." Greenwood hearing, *supra* 2, at 38. Rather, the agency had "from the beginning, gotten out in every way it could, and said, no, we are not the September 11 [F]und . . . ., which has said repeatedly [it is] only for the victims and their families of these three attacks." *Id.* at 43-44. Unfortunately, Dr. Healy bemoaned, "not everyone heard" this message. *Id.* at 38.

427. N.Y. EXEC. LAW § 172-d(4) (consol. 2002) (charities must apply contributions in a manner "substantially consistent" with the terms of the solicitation).

428. When the agency did receive gifts expressly restricted to a special purpose (e.g., creating a strategic blood reserve, for World Trade Center victims,), it respected these restrictions. *Id.* at 51-52 (testimony of Dr. Bernadine Healy).

were the actual terms of the Disaster Relief Fund[429] and the Liberty Fund, and what did the agency communicate to its donors?

Yet on another level, Mr. Spitzer may have been arguing that: (1) the actual, subjective intent of Liberty Fund donors was to benefit 9/11 victims only;[430] and (2) the Red Cross understood this—even if donors did not explicitly communicate their desires to the agency.[431] If so, one might ask "so what?" The donors' actual, subjective intentions regarding the donee's use of their gifts are, by themselves, legally irrelevant: the Red Cross was obliged to follow these intentions only insofar as they were externally expressed and communicated to it.[432] One can assert this, moreover, without denying that a charity is, generally speaking, ethically obliged (and politically advised) to cleave to its donors' actual but under-articulated wishes.

Alternatively, Mr. Spitzer may believe that given all the circumstances, the donors did in fact communicate their intentions to the Red Cross, and that the agency was obliged to honor these intentions even if they diverged from its own representations. Here one might point to the prodigious increase in gifts the Red Cross received after 9/11 as evidence that these donors intended to benefit 9/11 victims and *only* them. In the terminology of rhetoric, this assertion is known as *post hoc ergo propter hoc,* or "after this therefore because of this." Yet such a claim is both empirically and legally flawed. The desire to help 9/11 victims undoubtedly motivated many if not most of the Red Cross's donors to some

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429. Recall that only some of the gifts deposited in the Liberty Fund were actually designated for the "Liberty Fund." This is of course true of gifts made before the Liberty Fund was created, but not only them.

430. Greenwood hearing, *supra* note 2, at 33 (statement of Eliot Spitzer, New York State Attorney General) ("When people were writing their checks for $100, $200 or $10,000 and sending them in response to the PSAs that the Red Cross was running, *they believed* victims were going to get that money. I speak now as [a] New Yorker and I also speak for the victims in Pennsylvania [and] the victims in Virginia[. T]hey are supposed to get this money. This is not for [the Red Cross's organizational] continuity and it's not for reprogramming [by the agency for other purposes].") (emphasis added); Houghton hearing, *supra* note 393, at 41 (statement of Eliot Spitzer, New York State Attorney General) ("those who gave to the Red Cross in the aftermath of September 11 *intended unambiguously* that those funds be used for the victims of September 11") (emphasis added); *id.* at 47 (statement of Eliot Spitzer, New York State Attorney General) ("people gave [to the Red Cross] thinking those funds were going to benefit the victims[of 9/11]. You've got to use those funds to benefit the victims and not future contingencies, not amorphous issues that may arise in the future.").

431. Houghton hearing, *supra* note 393, at 39 ("What is [legally] relevant is what did they [the donors] intend when they sent that money in [to the Red Cross]. I believe that the Red Cross understood what they intended. That intent was that this money go to the victims of September 11 . . . .") (statement of Eliot Spitzer, New York State Attorney General).

432. AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 23 (4th ed. 1987) ("For practical reasons [the trust settlor's] undisclosed state of mind is regarded as immaterial. In the interest of accuracy, therefore, it is necessary in dealing with the creation of a trust and the terms of the trust to speak not of the settlor's intention but of his manifestation of intention").

extent. Yet this cannot fully explain the intentions of every donor. There are many reasons why people may have given, and each donor may have had a variety of reasons for doing so. For some people, the attacks may have reminded them of the general need for robust multi-disaster DROs. Others may have wished to help 9/11 victims, but only to meet their basic needs, not to enrich them. To honor such donors' intentions, the Red Cross should have stopped its 9/11 relief operations once basic needs were met.

Although the "after this therefore because of this" account of donor intent is factually incomplete, one might nonetheless wish to posit it as a rebuttable presumption. The rule might go something like this: When a general DRO receives supra-normal contributions following a high-profile disaster, it is legally obliged to spend these sums on that particular disaster, even if (1) the organization did not represent to donors that it would do this, and (2) the donors did not explicitly restrict their gifts to that use, unless (3) the donors expressly authorized the DRO to spend their gifts on other disasters and for other purposes. If so, such a rule should be rejected, and not simply because it would be difficult to administer.[433]

A charity is free, of course, to follow its donors' perceived wishes, even if the donors have not expressly communicated these to the agency. The Salvation Army, for example, used all unspecified "disaster relief" gifts received between September 11, 2001 and December 31, 2001, for its 9/11 relief operations.[434] Yet general DROs should remain formally free to use gifts motivated by one disaster to finance other relief operations—that is, barring express donor instructions to the contrary. This regime gives a charity more leeway to allocate funds efficiently and equitably among the various disasters to which it responds. For similar reasons, attorney generals should think twice before contesting a DRO's reallocations.[435] Changing the current regime to make it more accountable to donors' formally underarticulated wishes may also be unnecessary because non-legal sanctions work tolerably well at punishing charities and managers who flout such wishes, as the Liberty Fund fallout vividly illustrates. Allegations that an agency has violated donor intent can harm the organization's larger fundraising efforts and public relations.[436] Such charges can also tarnish a charitable manager's personal reputation for honesty.[437]

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433. What, for example, is the baseline and time frame for assessing whether a DRO's contributions following a given disaster are "supra-normal"?

434. Telephone Interview with Lt. Col. Tom Jones, Directory of National Community Relations and Development, The Salvation Army (Mar. 27, 2002). The Army divided such checks 3-to-1 between its New York and the Pentagon relief activities. *Id.* Recall too that the Red Cross voluntarily deposited into the Liberty Fund every gift for unspecific "disaster relief" that it received between September 11, 2001 and October 31, 2001. *See supra* notes 362-63 and accompanying text.

435. *See supra* notes 37-38 and accompanying text.

436. FISHMAN & SCHWARZ, *supra* note 39, at 271.

437. *See* Jonathan R. Macey, *Private Trusts for the Provision of Private Goods*, 37 EMORY L.J. 295, 320 (1988).

B. Uniformed Personnel Widows' and Children's Funds

The Red Cross was the most visible general DRO that sought to use post-9/11 donations for other purposes. Two other general DROs were also accused of engaging in the same behavior: survivor relief funds run by New York City's police officer and firefighter unions, respectively. No such charges, by contrast, were leveled against the New York City Police Foundation, which also disbursed funds to families of officers killed on 9/11.

1. The Patrolmen's Benevolent Association's Widows' and Children's Fund.—Twenty-three officers of New York City Police Department were murdered in the terrorist attacks at the World Trade Center. In the months following 9/11, donors contributed $14 million to a pre-existing charitable fund run by the New York City police union.[438] Of the three funds discussed in this section, this one inspired the most heated and prolonged controversy.

The Patrolmen's Benevolent Association of the City of New York, Inc. ("PBA") represents police officers in labor negotiations with New York City.[439] In 1980, the PBA created the PBA Widows' and Children's Fund[440] ("PBA Fund" or "Fund").[441] The PBA Fund's mission is "to provide aid and assistance to the widows, widowers and family survivors of [PBA-member] police officers slain in the line of duty."[442] Prior to 9/11, the Fund's resources and activities were modest. In FY 2000, for example, the Fund raised approximately $165,000 in contributions, and had accumulated approximately $189,000 in assets.[443] It served about one hundred eligible families,[444] and spent around $98,500 in scholarships, recreation, and holiday events.[445]

In the months after the terrorist attacks, the PBA Fund received

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438. Leonard Levitt, *Two Sept. 11 Families Sue PBA, Say Millions Have Been Held Back*, NEWSDAY (New York, N.Y.), July 24, 2002, at A17.

439. Some members of the PBA have lobbied to change its name to the gender-neutral "Police Benevolent Association of the City of New York, Inc." These efforts have been unsuccessful to date. William Van Auken, *Honoring Moira Smith PBA to Take "Men" Out of Union Label*, CHIEF CIVIL SERV. LEADER, Mar. 22, 2002, *at* http://www.nycpba.org/press-ch/02/ch-020322-name.html (last visited Aug. 29, 2002).

440. Its legal name is "PBA Widows & Orphans Fund, Inc." *See* Form 990, the PBA Widow's & Orphans Fund, Inc., Internal Revenue Service, Return of Organization Exempt from Income Tax, for Fiscal Year Ending June 30, 2000 [hereinafter PBA Widows & Orphans Fund Form 990], *available at* http://www.guidestar.org/2000/132/949/2000_132949036_1_9.pdf.

441. The PBA's directors serve as directors of the PBA Fund. *Id.* at Part VII, question 52.

442. *Id.*

443. *Id.*. On September 11, 2001, it had approximately $330,000 on hand. David Barstow, *Police Families Demand a Say in Handling of Benefit Fund*, N.Y. TIMES, Mar. 9, 2002, at B3.

444. *In re* Estate of John William Perry, Deceased, Affirmation in Support of Petition to Compel, Surrogate's Court of the State of New York, County of New York (July 2002), at 3 [hereinafter Perry, Affirmation in Support]

445. PBA Widows & Orphans Fund Form 990, *supra* note 440.

approximately $14 million in donations.[446] The Fund initially used its existing machinery to handle the new gifts; it did not create a separate account for the post-9/11 donations. Even so, the donors of approximately $8 million[447] (57% of the total) expressly restricted their gifts' use to benefit 9/11 families, indicating so on the check or in accompanying correspondence.[448] The PBA ultimately created a special account for the 9/11-restricted gifts, the sum total of which was divided evenly among the families of the 23 fallen police officers—around $350,000 apiece. Much of the remaining $6 million was distributed to the families of other officers, i.e., those killed in the line of duty before and after 9/11.[449] Unlike its gifts to 9/11 families, the union expressly justified its assistance to pre-9/11 widows on the basis of the recipients' financial distress. Some of these widows, a union official said, "are so poor they can't afford health benefits."[450]

Family members of three of the twenty-three police officers killed on 9/11 subsequently brought actions challenging the PBA's allocation of post-attack donations.[451] They argued that the remaining $6 million should also be distributed to the twenty-three 9/11 families, even though the donors did not expressly restrict their gifts for this purpose. They justified this demand on two grounds: (1) "the realities of the extent of [the PBA Fund's] previous historical fund-raising efforts"[452] and (2) the Fund's "targeted website solicitation."[453]

A lawyer representing the three families said that before 9/11, "[t]he only money in the PBA fund . . . was enough to fund a Christmas party and a barbecue."[454] The great disparity between the Fund's pre and post-attack donations, he claimed, demonstrated that post-9/11 donors intended their gifts to benefit 9/11 families only. We have seen this before: it is the "after this

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446. Levitt, *supra* note 438.

447. *Id.*

448. Perry, Affirmation in Support, *supra* note 444, at 4.

449. *See* Patrolmen's Benevolent Association of the City of New York, Inc., *Donations*, http://www.nycpba.org/donations.html ("The widows and children of all officers killed in the line of duty are eligible beneficiaries of the PBA Widows and Childrens Fund.") (last visited Aug. 29, 2002). The PBA does not seem to have considered the possibility of dividing the entire $14 million evenly among the families of all its fallen members.

450. Levitt, *supra* note 438.

451. *See In re* Application of Margaret McDonnell and Frank J. Dominguez, Affidavit of Jayne Conroy in Support of Application to Examine Records and for an Accounting to Aid in Commencing an Action Against Patrolmen's Benevolent Association of the City of New York, *Inc.*, at n.4 (filed in the Supreme Court of the State of New York, County of New York, on July 10, 2002) [hereinafter Affidavit of Jayne Conroy]; Perry, Affirmation in Support, *supra* note 444. Ms. McDonnell lost her husband Brian, Mr. Dominguez lost his brother Jerome, and Patricia Perry lost her son John William Perry in the World Trade Center attacks.

452. Affidavit of Jayne Conroy, *supra* note 451. The PBA has refused to reveal how much money it has collected since January 30, 2002. *Id.* at para. 11.

453. *Id.* at 3 n.4.

454. Stephanie Saul, *Disputes Linger Over 9-11 Donations*, NEWSDAY, May 9, 2002, at A16.

therefore because of this argument" discussed above.[455] These families also alleged that the PBA Fund's website misled donors into thinking that their donations would go to 9/11 families only. The PBA solicited donations to the Fund on two different pages on its Internet website. The first page represented the Fund as assisting the families of all New York City police officers killed in the line of duty. Entitled "To Our Fallen Comrades," it listed the names of officers killed both on 9/11 and afterwards, and contained a link to a list of officers killed before the attacks.[456] At the bottom of the page was the name "PBA Widows & Childrens Fund." The second page connected gifts with distributions to 9/11 families. It was titled "Attack on America" and contained a graphic of the Statute of Liberty. The center of the page consisted of a testimonial from a Dallas police detective named Joe Thompson who "grew up in the Bronx."[457]

> Thompson is returning to his hometown . . . with a $15,000 check for the families of New York City police officers killed in the attacks on the World Trade Center . . . . [He] will present the check to the New York Police Department [sic] Widow's and Children's Fund. "This is the quickest way to get family members financial assistance," said Detective Thompson.

The survivors of two 9/11 officers brought an action in a court of general jurisdiction regarding the PBA's alleged "failure to disburse and properly account for their [the families'] proportionate shares of the . . . Post-9/11 Donations."[458] They sought an order directing the PBA to produce all documents on how the donations were distributed, and requested an independent accounting of this distribution. The New York Attorney General moved to intervene and for dismissal of the action "as unwarranted, unnecessary and potentially harmful to beneficiaries of the [PBA] Fund and to charity in general . . . ."[459] A third plaintiff sought similar relief in probate court, alleging that the PBA "has converted for its own use the assets of the intended beneficiaries" of the post-9/11 gifts to the Fund.[460]

In December 2002, New York courts dismissed both actions. In the first case, the judge found that the plaintiffs had failed to present any evidence of fraud or fiduciary breach by PBA Fund managers, and refused to let plaintiffs use

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455. *See supra* note 433 and accompanying text.

456. Patrolmen's Benevolent Association of the City of New York, Inc., *To Our Fallen Comrades*, http://www.nycpba.org/memoriam.html (last visited Apr. 17, 2002).

457. Patrolmen's Benevolent Association of New York City, Inc., http://www.nycpba.org (last visited Apr. 16, 2002) (The solicitation read "All donations for the PBA Widows and Childrens Fund should be sent to" the address listed).

458. Affidavit of Jayne Conroy, *supra* note 451.

459. *Matter of McDonnell*, N.Y.L.J., Dec. 18, 2002, at 23 (paraphrasing the attorney general).

460. *In re* Estate of John William Perry, Deceased, Petition to Compel Discovery of Property, Surrogate's Court of the State of New York, County of New York (July 2002) (on file with author).

discovery in the hopes of finding such evidence.[461] In the second case, the probate court found that it lacked jurisdiction because the monetary relief sought would be paid directly to the deceased officer's survivors instead of to his estate.[462] In both cases, the judges noted that the Attorney General's office had looked into the Fund's records and found nothing amiss.[463]

2. Uniformed Firefighter's Association Widows' and Children's Fund.—Since its inception, the Uniformed Firefighter's Association of Greater New York Local 94 ("UFA" or "Union") has provided assistance to the families of New York City firefighters who died in the line of duty.[464] In 1980, the UFA formalized this practice by creating the UFA Widows' and Children's Fund ("UFA Fund" or "Fund").[465] The Fund's purpose is "to accept donations to be used [to] relieve the need of the widows, children and dependents of the members of the UFA . . . who died or shall die in active service."[466] Before 9/11, the Fund had modest resources. In fiscal year 2000, it received around $163,000 in contributions, and had assets worth around $832,000.[467] Its programming budget that year was $164,000, which paid for an annual Christmas party and scholarships to dependents. [468]

Shortly after the attacks, the UFA and two other firefighter associations formed a new entity whose sole purpose was to raise money for the families of members killed in attacks—the New York Firefighters 9/11 Disaster Relief Fund.[469] The creation of this 9/11-specific fund did not stop the public from deluging the pre-existing UFA Fund with donations after 9/11. In its promotional

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461. *Matter of McDonnell*, *supra* note 459.

462. Mike Claffey, *Judges Toss Suits Over 9/11 PBA Fund, Daily News*, Dec. 19, 2002, at 42.

463. *Id.*; *Matter of McDonnell*, *supra* note 459.

464. UFA History—Representing NYC's Firefighters, *at* http://ufalocal94.org/pages/rep_nycs_ff.html (last visited Aug. 24, 2002).

465. *See* UFA History—Widows' & Children's Fund, *at* http://www.ufalocal94.org/pages/widows_childrens_fund_hist.html (last visited July 8, 2002). The Fund is organized as a nonprofit corporation under New York State law, and shares the same board of directors with the UFA.

466. Stephanie Strom, *Families Upset as Fire Union Denies Them Fund Benefits*, N.Y. TIMES, May 12, 2002, at 29 (quoting UFA Fund's by-laws). The Fund's 990 Form describes its key activity as "award[ing] scholarship grants to dependents of the [UFA] who died in line-of-duty circumstances." Form 990, the UFA Fund's IRS Return of Organization Exempt from Income Tax, for Fiscal Year Ending July 31, 2000, at 14 [hereinafter UFA Widow's and Children's Fund Form 990], *available at* http://documents.guidestar.org/2000/133/047/2000-130047544-1-9.pdf.

467. UFA Widow's and Children's Fund Form 990, *supra* note 466, at 1.

468. In fiscal year 2000, the UFA Fund spent 46% of its year's resources on the annual Christmas party. *Id.* at 1-2.

469. New York Firefighters 9/11 Disaster Relief Fund, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, Form 1023, Schedule A, Part I, 1 (Sept. 21, 2001) (on file with author). This charity is a joint project of the UFA, the fire officers union's New York local, and the International Association of Firefighters (IAFF). International Association of Fire Fighters, *IAFF Establishes Charity Fund*, http://daily.iaff.org/fund.htm (last visited Aug. 24, 2002).

materials for the UFA Fund, the union's website stated that donations would be "distributed to the families of our fallen firefighters."[470] As of December 2, 2001, the UFA Fund had received $29 million, prompting its treasurer to say that "[w]e have been taken care of . . . ."[471] Yet the Fund continued to receive and accept donations, ultimately raising $70 million. This amount is 429 times the Fund's income in FY 2000 and 84 times its assets.

The UFA initially planned to use the entire $70 million to help the surviving spouses, children and dependents of *every* UFA member killed in the line of duty, with no additional payouts for all families.[472] More specifically, the Union proposed to make an initial lump-sum payment of $20,000 to the surviving spouse of every fallen member, followed each year by a payments of $3000 until the widow's death.[473] Disbursements would also be made to members' children and dependents.[474] From the UFA's perspective, this approach was consistent with two key principles that the Union never forgets those members who made the "supreme sacrifice," and that no member's sacrifice is morally (or financially) more worthy than another's.[475] The UFA did not intend to make any payments to the parents, siblings and other survivors of the 97 single firefighters who died on 9/11 without children or dependents.[476] This exclusion, the UFA argued, was dictated by the Fund's by-laws, which provided that the donations were for "widows, children and dependents."

Some 9/11 families argued that this proposal violated donor intent in two respects.[477] First, those who contributed to the UFA Fund actually intended to benefit only the families of 9/11 firefighters, for the same reason advanced in the PBA Fund case: "after this therefore because of this."

> The fact that the UFA Widows and Children's Fund has raised so much money since September 11—more than 75 times the amount that is ordinarily in the fund—is proof that the donors intended the money to go

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470. Seessel, *supra* note 14, at 42.

471. Barstow & Henriques, *supra* note 248, at 1A.

472. Thomas LaMacchia, *Caring for Our Own: Funds Route Money to Our Widows and Children* (Feb. 2, 2002), *at* http://ufalocal94.org/firelines/2002/fl_feb_02/fl_feb_02_funds_4_widows.html.

473. Ingrassia & Saul, *supra* note 231.

474. Under the original plan, each child was to receive $3000 per year until the age of twenty-four, and then a final payment of $50,000. *Id.*

475. Telephone Interview with Michael Block, General Counsel, UFA (May 11, 2002) [hereinafter Block Interview] (on file with author).

476. Seessel, *supra* note 14, at 42 (ninety-seven single firefighters died on 9/11).

477. *See, e.g.*, New York FD/PD Widows Support, Discussion Board, UFA's Widows' and Children's Fund, *at* http://www.emergingglobe.com/nyfd (last visited May, 28, 2002) (entry posted by JoeH on April 7, 2002: 10:25:39 PM) (arguing that UFA cannot dispose of donations to the UFA Fund "as they see fit. The money belongs to the families of the firefighters that died on September 11 . . . . [P]eople gave to assist the families of September 11 firefighters exclusively.")

to the families of September 11 victims.[478]

Second, the Union's website misled donors into thinking that their donations would benefit 9/11 families exclusively,[479] when in truth it would not do so unless the donor specifically requested it.[480] Furthermore, some third parties advised potential donors that the UFA Fund was exclusively for 9/11 families.[481] Although such utterances cannot be ascribed to the Union,[482] they provide more evidence of what the UFA fund's donors likely thought they were supporting. j For all these reasons, the Union was obliged to spend the entire $70 million on 9/11 families, a duty it would breach by diverting even some of the monies to other families.

The Union's proposal was also improper, some 9/11 families argued, because the donors intended to benefit the families of both married and single firefighters, i.e., to provide help, *"regardless of the hero firefighter's marital status."*[483] These donors believed the Fund would do so, it was explained, because the UFA's website simply said that donations would be "distributed to the families of our fallen firefighters," without defining the term "family." Given this silence, donors reasonably concluded that the Fund would also benefit the parents, siblings, or other next of kin of single, childless firefighters killed on 9/11 ("single 9/11 heroes").

Of these two claims—(1) that the UFA Fund's donors intended to benefit 9/11 families only; and (2) they also intended to benefit the next of kin of single 9/11 heroes—the second seems harder to sustain. Although the UFA's website included text that donations would go to 9/11 families (but not necessarily only them), it did not state that aid would go to anyone other than surviving spouses

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478. Saul, *supra* note 454, at A16.

479. Block Interview, *supra* note 475.

480. Claffey, *supra* note 257 (attorney for 9/11 families claims that UFA had misled donors because only a small portion of the fund—monies given expressly for families of Sept. 11 victims—was distributed immediately).

481. *See, e.g.*, http://www.networkforgood.org/911/donate/fire_fighters.html ("The Uniformed Firefighters Association of Greater New York has created the UFA Widow's and Children's Fund in response to the tragedy that has gravely affected the nation and its fallen brothers") (last visited Aug. 24, 2002). One site stated that "that "[a]ll monies in the [UFA] fund go directly to benefit the widows and children of the fallen fire fighters of the World Trade Center Tragedy. . . ." Run for America, *Fund Descriptions*, http://www.runforamerica.com/events/2001/RunForAmerica/fundDescriptions.asp (last visited Aug. 24, 2002).

482. That is, unless it can be shown that the Union knew about such utterances and took no steps to stop or correct them.

483. AP State & Local Wire, *Some Firefighters' Families Upset Over Union Charity Plan, Lawyer Says* (May 9, 2002). Families of 9/11 victims also complained that the UFA Fund was not distributing the collected funds fast enough. *See, e.g.*, Claffey, *supra* note 257 (lawyer for families of 9/11 victims asserts that "[d]onors from all over the country gave to provide immediate help to the families of hero firefighters. They surely did not want their money held in union coffers for years to come.").

and children. In any event, the fund's name—the UFA Widows' and Children's Fund—should have notified would-be donors as to the identity and limited scope of the beneficiary class. Yet 9/11 families ultimately dropped the first claim, and maintained the second, especially (perhaps unsurprisingly) relatives of the ninety-seven 9/11 heroes. The UFA's plan, their lawyer charged, violated "the *obvious* donor intent" to help the families of married and single 9/11 heroes alike.[484]

The Union initially resisted this demand on the basis of principle and precedent.[485] The Fund had never been used to benefit the parents and siblings of unmarried firefighters. Doing so here would violate the Union's norm of evenhandedness by treating the survivors of single 9/11 heroes better than the kin of single firefighters killed on other occasions. The parents of unmarried 9/11 firefighters invoked a different equality norm: all 9/11 heroes were equally deserving regardless of marital status. "My son is just as dead as a married man who is dead," said one mother.[486] The union's failure to give her any portion of the Fund amounted to his "being devalued as a hero."[487] This appeal elided the issue of whether the next of kin actually suffered financial distress as a result of losing a son or sibling: "It's not a question of immediate need," said another mother. "It's a question of fairness."[488]

In early May 2002, an attorney for 9/11 families accused the UFA of "illegal conduct" in handling the Fund, and asked Eliot Spitzer, the New York State Attorney General, to intervene.[489] The Union also asked Spitzer to become involved "in order to avoid litigation and unnecessary acrimony."[490] The Attorney General's office apparently did not object to the Union's plan to use

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484. AP State & Local Wire, *supra* note 483; Claffey, *supra* note 257.

485. Block Interview, *supra* note 475. UFA officials also argued that they lacked authority under the Fund's bylaws to make payments to parents and/or siblings of fallen firefighters. The UFA may have been estopped from asserting this, however, because it had already accepted and distributed some gifts to all 9/11 families when the donors expressly requested this. *See* Strom, *supra* note 466.

486. *Id.*

487. Ingrassia & Saul, *supra* note 231 (quoting Dee Ragusa, whose son, Michael, was a firefighter in Engine Co. 279 killed in the attacks).

488. Ingrassia, *supra* note 248 (quoting Joan Molinaro). At least one relative did attempt to justify payment on the basis of financial need. The rather strained and speculative nature of this attempt shows why most avoided it. *See* Strom, *supra* note 466 (Mother of slain firefighter asks "How do they [the UFA] know that we didn't depend on him, that we didn't have plans to buy property with him or a house or a boat? How do they know that? I have not been able to work a day since Sept. 11. I have been devastated and destroyed by my son's death. Does that make me not dependent on him?").

489. Claffey, *supra* note 257.

490. Saul, *supra* note 254; *see also* Seessel, *supra* note 14 (quoting full-page ad that the UFA sponsored in the May 19 issue of *The New York Times,* which stated that, inter alia, the dispute over its use of post-9/11 donations was being resolved "in consultation with the Charities Bureau of the New York State Attorney General's Office")

some post-9/11 gifts to help "historic widows." At the same time, the office seems to have sided with the single 9/11 heroes' families that Fund monies should be distributed to them. Under the final plan announced in mid-July, 2002, the UFA promised to pay $50,000 immediately to the spouse of every married firefighter ever killed in the line of duty and an additional sum every year thereafter for the remainder of the spouse's life. Also, the Union would make a single payment of $50,000 to the single 9/11 heroes' next of kin, but on this point, the Union departed from its equality norm, as it would pay nothing to the families of single firefighters who died in other fires on other days.

3. The New York City Police Foundation Heroes Fund.—The New York City Police Foundation, Inc. (the "Foundation") is a 501(c)(3) municipal nonprofit organization that accepts tax-deductible contributions to the New York City Police Department ("NYPD" or "Department"), and spends these monies to support the Department's activities.[491] Among other projects, it equips officers with bullet-resistant vests, offers rewards to people who help solve violent crimes, maintains the NYPD mounted and canine units, and runs programs designed to reduce the incidence of suicide among officers.[492] It ordinarily has little contact with the families of fallen NYPD officers, and prior to 9/11 did not make cash distributions to them.[493]

In FY 2000, it received $1.9 million in donations.[494] After the attacks, it set up a segregated fund called the Heroes Fund whose stated mission was "to meet the emergency needs of the NYPD and its personnel."[495] Approximately $10 million in donations was raised, $1.8 million of which donors expressly earmarked for the families of the fallen officers.[496] The Foundation used this amount to make payments to a suitable survivor, such as a spouse, domestic partner, children, or dependants.[497] The balance has been used to support departmental projects such as counseling, buying new bullet-resistant vests, establishing a DNA investigation center, and purchasing protective gear for rescue workers.[498] Although it distributed less than 20% of the Heroes Fund to the families of 9/11 police heroes, the Foundation has received no complaints from these families—only "extremely kind letters of thanks."[499]

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491. New York City Police Foundation's Internal Revenue Service Form 990, Return of Organization Exempt from Income Tax, for Fiscal Year ending June 30, 2001 [hereinafter NYCPF Form 990], *available at* http://documents.guidestar.org/2000/132/711/2000-1327-1-9.pdf

492. New York City Police Foundation brochure (Mar. 2001) (on file with author).

493. *Id.*

494. NYCPF Form 990, *supra* note 491.

495. *See* New York City Police Foundation, *at* http://www.nycpolicefoundation.org/ (last visited Aug. 29, 2002).

496. *Id.*; E-mail from Lori Wilson, Director of Programs, New York City Police Foundation (July 29, 2002) (on file with author).

497. New York City Police Foundation, *supra* note 495.

498. *Id.*

499. *Id.*

C. Exploring the Connections Between Donor Intent and Private Benefit

All the four charities discussed in this section share something in common: each planned to use only some of the donations received after 9/11 to aid the victims of that day's attacks. Yet only three of these entities—the Red Cross and the two union-run widows' and children's funds—were subsequently accused of misrepresenting their charitable goals and violating their donors' intentions. Each case, moreover, incited different amounts of public indignation and official scrutiny to which the impeached organizations responded in different ways. What accounts for such varied responses to relatively similar conduct? How illicit or damnable was the conduct at issue, and how redemptive or praiseworthy were the charities' responses to their critics? To these questions I now turn.

1. Demands to Honor Donor Intent Produced (More) Private Benefit.—Mr. Spitzer charged he Red Cross with using Liberty Fund dollars for unsolicited purposes and braking faith with its donors. The appropriate remedy, he believed, was a court order directing the agency to spend the entire fund on 9/11 victims. This cause of action was objectionable on several grounds. First, it second-guessed the agency's determination that it had relieved the victims' disaster-related distress—a matter over which DROs have broad discretion.[500] Second, it strong-armed the Red Cross into distributing long-term financial aid to 9/11 victims who were not financially needy and thus violating the bar against private benefit.

As noted above, 501(c)(3) exempt purposes are not necessarily identical to common law charitable purposes and vice versa.[501] For this reason, Section 104 of the Victims of Terrorism Tax Relief Act vividly demonstrates why this is so. Section 104 modifies the criteria for tax exemption under IRC 501(c)(3) on a one-time basis. More specifically, it authorizes 501(c)(3) entities to provide what would otherwise be impermissible assistance to 9/11 victims—long-term payments unrelated to need—without compromising their federal tax advantages.[502] Section 104 does not purport to alter the criteria for "charitable" designation under state common law, nor would federalism principles permit it to do so. As compared to legislators, common law courts have less leeway to suspend long-standing charity law principles to accommodate—popular sentiment in a single, emotionally-charged case.[503]

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500. *See supra* notes 183-93 and accompanying text. Greenwood hearing, *supra* note 2, at 32, 34 (testimony of Dr. Bernadine Healy) ("We worked with them [i.e., the families of those killed on 9/11] vigorously. Everything that we thought we could do, everything that was within our mission we did . . . We exercise judgment, some people may not agree with some of the categories of use [of Liberty Fund dollars] that we have outlined. But, we have experience in these areas and exercised our judgment in the best interest of what we thought was wise and caring stewardship of these precious resources.").

501. *See supra* note 72 and accompanying text.

502. *See supra* notes 273-83 and accompanying text.

503. This is not to say that courts never do this, although they will not present the results as such. See my discussion of the majority decision in *Doyle v. Whalen*, *supra* notes 156-62 and

Of course, the fact that state authorities can invoke common law charitable principles to curtail private benefit permissible under federal law does not mean that they will. Until Congress intervened, the IRS was advising 501(c)(3) entities to make payments to 9/11 victims on the basis of an objective, case-by-case assessment of their financial need.[504] Whereas the IRS's advice to DROs would have reduced the risk of private benefit occurring, the New York Attorney General's actions likely had the opposite effect. In response to denunciations and threats from Mr. Spitzer (among others), the Red Cross ultimately distributed $45,000 to the estate of each 9/11 decedent, regardless of the heirs or devisee's financial needs. These "estate gifts" will be dwarfed by the $1 million-plus awards that the typical survivor will receive from the federal government's Victim Compensation Fund. Some recipients may also include "laughing heirs," a wills-and-estates term to describe an heir distant enough to feel no grief when a relative dies and leaves a windfall.[505] The Attorney General also pressed the UFA Widows' and Children's Fund into paying $50,000 to the parents, siblings or other next of kin of single firefighters killed on 9/11. As compared to the surviving spouses and children, these relatives are less likely to have been financially dependent on the single heroes' income. These relatives, moreover, have already received $418,000 from the IAFF Fund and $186,650 from the Twin Towers Fund in addition to the Victim Compensation Fund award.

Note the dynamic and its irony: To deflect relatively inconclusive allegations of misrepresentation and disloyalty to donor intent, the Red Cross and the UFA made payments that by any reasonable account violated the bar against private benefit.

2. Explaining the Different Reactions to Similar Conduct by Different Charities.—Whatever the legal verdict on the Red Cross' conduct, it was not all that different from what the other multi-calamity charities did. All used post-9/11 contributions for non-9/11 purposes, even though some of their solicitations focused primarily on 9/11 relief, and their donors' actual, subjective intentions were as open to speculation as the Red Cross'. The Liberty Fund compares rather favorably to the New York City Police Foundation's post-9/11 Heroes Fund. As between a "Liberty Fund" and a "Heroes Fund," by its very name, the latter connotes a more singular focus on direct relief to survivors of 9/11 victims. Yet the Heroes Fund paid out only 18% of the donations it received to 9/11 families—neither more nor less than what its donors had expressly designated for that purpose. The Red Cross, by contrast, originally planned to use over 56% of the Liberty Fund to provide direct relief for 9/11 victims.[506] This was more than what its donors had expressly restricted for that purpose.

Although the four charities initially approached 9/11 relief in similar ways, each experienced different amounts of pressure to spend all post-attack

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accompanying text.

504. *See supra* notes 233-35 and accompanying text.

505. BLACK'S LAW DICTIONARY, *supra* note 53, at 728 (defining "laughing heir").

506. This 56% figure refers to the Liberty Fund's balance as of October 12, 2001. *See supra* notes 378-80 and accompanying text.

contributions on 9/11 relief, and each responded to its critics in a different manner. At least three factors help account for these variations: the nature of the potential beneficiaries, the relationships among the different classes of potential beneficiaries, and the political incentives of public officials.

The Red Cross originally planned to divide Liberty Fund monies between two groups: those harmed on 9/11 and those harmed or at risk from harm in future attacks. The former group consists of a relatively manageable number of identified individuals, each with a large financial stake in the Liberty Fund's assets. The latter group consists of potentially everyone living in the United States and Americans overseas, and each member's current stake in the Liberty Fund is minuscule: it equals the probability of being injured or killed in a future terrorist attack, multiplied by the present value of any payment that he or his survivors would receive. As between actual versus hypothetical or statistical victims, it is much easier for the former to organize to demand Liberty Fund aid. In addition to this collective action problem, Americans not directly harmed by 9/11 (i.e., potential Red Cross beneficiaries) felt tremendous sympathy for the victims. They were willing to forgo their individual stakes in the Liberty Fund to promote the victims' well being.

Contrast the Liberty Fund with the two union-run widows' and children's funds. Their managers considered allocating post-9/11 donations among at least three groups: surviving spouses and children of union members killed on 9/11; widows and children of members kill before 9/11 (a.k.a. the "historic widows") and in the future; and the surviving parents, siblings, or next of kin of single 9/11 heroes. Unlike the victims of future terrorist attacks, however, the historic widows were not abstractions: they were real people living on fixed pensions not adjusted for inflation,[507] some of whom were "in desperate need of support."[508] It was much easier for 9/11 families to empathize with the historic widows and vice versa.[509] It is not so surprising, then, that the vast majority of 9/11 families—now financially secure if not prosperous from other sources—were willing to "share" post-9/11 contributions with the historic widows, even though it meant less money for themselves.[510] It helped too that there were relatively few historic widows of firefighters—around 106[511]—as compared to the 344

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507. William Murphy, *Aid for Families of Pre-WTC Heroes*, NEWSDAY, Apr. 5, 2002, at A6.

508. LaMacchia, *supra* note 472.

509. This sense of community was reflected in expressions of empathy by pre-9/11 widows for 9/11 widows, notwithstanding the disparities in aid each received for their respective losses. *See, e.g.*, Michele McPhee & Robert Ingrassia, *Heartbroken Families to Receive $1M in Aid*, N.Y. DAILY NEWS, Dec. 2, 2001, at 6 ("One widow who lost her firefighter husband in [the line of duty in] 1997 said she felt good about the tremendous outpouring of aid for the Trade Center uniformed victims' kin. "I don't feel left out. I realize past widows didn't get that kind of money, but I'm happy for them. It's never easy to lose your husband.").

510. Only three of twenty-three families of New York City police officers killed on 9/11 demanded that the PBA Fund spend all post-9/11 donations on the 9/11 families. "Most of the 23 families are embarrassed by this [litigation]," a Union official said. Levitt, *supra* note 438.

511. *Id.*

firefighters killed on 9/11. A larger number would have made it costlier and thus less attractive for 9/11 families to let others participate.

Lastly, it is reasonable to ask why the New York Attorney General threatened to sue the Red Cross unless it used everything raised after 9/11 for direct relief to attack victims, but not the unions and the Police Foundation. Similarly, why did Mr. Spitzer permit the unions and the Police Foundation to finance victim payments using only those dollars that donors had expressly restricted for that purpose, but not the Red Cross? Here, one might note that the attorney general's post is an elected office, and that the Red Cross was allocating monies between 9/11 victims—a large percentage of whom were New Yorkers—and future victims of terrorism, a large, diffuse and abstract group. The disputes between local unions and 9/11 families, by contrast, dealt with allocating dollars among real and compact groups of very agitated (understandably so) New Yorkers. A state official could thus not get involved without running the risk of offending at least one group of constituents. To reduce that risk, the prudent politician would likely seek resolutions that split differences and avoided humiliating any party. Additionally, the political costs of challenging local union leaders, a powerful force in New York politics, are considerably higher than going after the Red Cross, which is legally barred from engaging in substantial lobbying or any electoral politics.[512]

CONCLUSION

The outpouring of charitable contributions following 9/11 not only strained the logistical abilities of many DROs, it also overwhelmed key parts of the legal regime that governs them. Some of the largest charities engaged in 9/11 relief received more donations than they could pass onto victims without enriching them, as opposed to simply relieving their suffering. Such distributions, if made, would violate the bar against bestowing excess benefit on private interests. At the same time, these charities were either unwilling or unable to return the surplus sums that could not be used for the solicited or intended purposes. They resembled a python that has swallowed an oversized pig it can neither digest nor expel.

The bar against private benefit, which originated in the common law of charitable trusts, has been incorporated into the federal law of tax-exempt organizations. By enacting Section 104 of the Victims of Terrorism Tax Relief Act, Congress essentially waived this bar for 501(c)(3)-exempt DROs engaged in 9/11 relief. It freed such entities to make payments without regard to actual need. These distributions could make victims financially whole or even better off, so long as they were calculated "in good faith" on the basis of consistent, objective, and "reasonable" criteria. Section 104 enabled the deluge of post-9/11 donations to pass through the charitable conduit with relatively few obstructions.

Several multi-disaster, general DROs sought to resolve the surplus problem

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512. IRC 501(c)(3).

in a different way—by using some post-9/11 gifts for purposes other than providing direct relief to 9/11 victims. The union-run funds looked backwards: they wished to help the survivors of earlier members whose line-of-duty deaths inspired fewer donations. The Red Cross looked forwards: it wished to build its capacity to help the victims of future terrorist attacks. Either way, spreading the dollars more widely seemed both more sensible and fairer. Yet in attempting to avoid one set of hazards, these charities crashed into another: the wrath of donors (as well as officials, victims, commentators and others) demanding that everything raised after 9/11 be spent on the victims of those specific attacks. These parties invoked another key principle of charity law: that charitable donations be used for the purposes for which they were solicited and/or given.

Section 104 did not abrogate the state common law prohibition against private benefit; at most, it authorized one class of nonprofit organizations to enrich private interests without forfeiting their federal tax advantages. Even so, state officials did not block DROs from making payments that enriched some 9/11 victims. To the contrary, several DROs were pushed into making at least some unlawful distributions, in order to duck relatively weaker allegations that they had misrepresented their purposes or violated donor intent.

The charitable response to September 11 was singular in very many ways. How will this experience affect the conduct of DROs? The answer may depend upon the type of DRO involved. In the future, general DROs will seek ways to enhance their leeway to reallocate resources among operations, and avoid being pressured into spending more on a particular disaster than they deem warranted. To this end, they may follow the example set by Red Cross' new Donor DIRECT initiative, which more conspicuously notifies donors that unrestricted donations might be used for other purposes, discourages them from making disaster-specific gifts, and informs them when enough funds have been raised for a particular relief operation.

The recent past may have taught disaster-specific DROs a very different set of lessons. For some, the ideal such entity operates like a private trust but enjoys the tax advantages of charitable status. Its managers have the freedom to aid a definite group of beneficiaries regardless of need, to enrich them if resources permit, under the auspices of a tax-exempt organization that is eligible to receive tax-deductible contributions. The 9/11 experience suggests a strategy for achieving this result: in the wake of a major calamity, managers of disaster-specific DROs should try to raise as much money as they can without worrying if it will be too much. If a surplus does arise, then the interested parties (the DROs themselves, their donors and intended beneficiaries) can lobby public officials to waive the "private benefit" bar in their particular case. When emotions run high and are widely shared, these officials may be loath to interpose themselves between donors and the objects of their altruism.

The charitable response to the September 11 attacks revealed much about the politics and public relations of donative surplus, but exposed no great or unpardonable flaw in charity law's method of handling this situation. Even so, dissatisfaction with the performance of disaster relief organizations may prompt some to seek deep changes in bedrock charity law principles. To avoid that possibility, perhaps the better course was to let this pig to pass through the

python, so to speak, such that the legal framework would readily resume its prior shape, and avoid being permanently distorted. In that way, a hard case will not have made bad law.

PROVIDING COMPENSATION FOR HARM CAUSED BY TERRORISM: LESSONS LEARNED IN THE ISRAELI EXPERIENCE

HILLEL SOMMER*

INTRODUCTION

Terrorism has existed in Israel in various manifestations and degrees for several decades now. This paper is being written as Israel is experiencing one of the most severe waves of terrorism in its history, killing hundreds of civilians, leaving behind thousands of wounded, and causing significant damage to much of the business community and to the economy.

Israel has devised comprehensive legislative responses[1] to two of the primary issues arising in the context of compensation for harm caused by terrorism. First, the Victims of Hostile Action (Pensions) Law, 1970 ("VHAPL"),[2] provides compensation for bodily injuries suffered in terrorist attacks, as well as compensation to family members of deceased victims. Second, the Property Tax and Compensation Fund Law, 1961,[3] provides compensation for property damage caused by terrorism.

The resulting Israeli system of compensation, following several major modifications, has now reached stability. It is, unfortunately, the product of significant experience in administration, both in terms of the time period involved and the number of events and victims involved.

The main difference between the compensation scheme devised in the United States following the events of September 11, 2001 ("9/11") and the Israeli system is that the Israeli scheme is a permanent system, continually in place, the result of extensive and lengthy consultation, rather than an ad hoc quick fix arrived at under severe time constraints in the emotional aftermath of major terrorist attacks and causing multiple issues of inequity.

Yet, not all types of harm caused by terrorism are covered by these permanent legislative schemes. The loss of income suffered by businesses is

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* Lecturer in Law, Radzyner Law School, The Interdisciplinary Center, Herzliya, Israel. I am grateful to Warren F. Schwartz for inviting me to present this paper at the Conference on the Law and Economics of Providing Compensation for Harm Caused by Terrorism, sponsored by the John M. Olin Program in Law and Economics, Georgetown University Law Center. I also want to acknowledge the valuable comments by the other conference participants and those of my colleagues Guy Seidman and Assaf Jacob. Finally, I am grateful to Yael Tabak for excellent research assistance, and to Marilyn Kaplan and Allison Kaplan Sommer for valuable editorial assistance.

1. One commentator analyzing all legislative measures (including criminal law and the effect of anti-terrorism laws on civil rights) in three countries affected by terrorism (Great Britain, Japan and Israel) described the Israeli legislation providing assistance to victims of terrorism as "[t]he most striking Israeli legislation." Matthew H. James, *Keeping the Peace—British, Israeli, and Japanese Legislative Responses to Terrorism*, 15 DICK. J. INT'L L. 405, 438 (1997).

2. 24 L.S.I. 131, (1969-70).

3. 15 L.S.I. 101, (1960-61).

generally not compensated, except in some cases involving ex post negotiations between the business community, the government, and regulators.

Part I of this paper describes and analyzes the compensation for bodily injuries and the compensation to family members of deceased victims offered by the Israeli government. Part II of the paper describes and analyzes the compensation for property damage caused by terrorism. In the first two sections, I have provided a rather comprehensive account of the Israeli compensation schemes, primarily in the footnotes, for those readers who may be interested in the details. Part III of the paper provides observations on the advantages and disadvantages of a permanent compensation scheme, such as the Israeli scheme, as compared with the compensation scheme devised in the United States for victims of the 9/11 tragedy.

I. COMPENSATION FOR BODILY INJURIES AND DEATH

A. A Brief History of Israeli Compensation of Civilians for War and Terrorism Damage[4]

Israel was born in a long independence war, followed by five wars in a period of forty-four years and frequent waves of terrorism. Both the wars and the terror acts have affected Israel's civilian population, and, in certain cases they could not be easily distinguishable from each other.[5] Since the early days of the state, the Israeli legal system provided for compensation to civilians who were wounded and to the families of those killed as a result of war or terrorist attack. The original legislative scheme was limited to compensation for harm caused by war. When terrorism emerged as a permanent feature of the Middle East conflict, compensation was extended to civilian victims of terrorism.

As an Israeli professor of social work has correctly observed, although most social welfare programs in Israel have been going through major financial cuts, the compensation schemes for victims of war and terrorism have been enlarged, adding more benefits for more recipients.[6]

On November 29, 1947, the United Nations (U.N.) decided to establish a Jewish state and an Arab state in the territory under a British mandate, and the state of Israel declared its independence on May 14, 1948, pursuant to the U.N. decision. Since Israel's Arab neighbors refused to accept the U.N. plan or to recognize the state, Israel started its existence with a lengthy independence war, terminating with an armistice in February 1949. With the Declaration of Independence, the interim government established the Ministry of War Victims,

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4. For a comprehensive historical analysis, see Uri Yanay, *Ha-siyua Le-ezrahim Nifgaey Peuolot Eiva* [*The Assistance to Civilians Harmed by Hostile Acts*], 40 BITACHON SOCIALI 35 (1993).

5. At the present time, for example, several of the terrorist attacks on Israeli civilians were sponsored by semi-formal or formal organizations of the Palestinian Authority. The distinction between "war" and "terrorism" may also involve political views.

6. Yanay, *supra* note 4, at 36.

which operated under emergency legislation to assist war victims and refugees. In 1951, the first law providing compensation for property damage was enacted.[7]

After the final armistice was signed in 1949, there was hope that the state would be secure enough to develop normally. Within a few years, however, it became clear that this was not the case. The primary security problems were border raids by individuals and small groups who caused death, injury, and property damage in the border towns and villages. At first, the government provided compensation to some of the victims on a case-by-case basis and without any clear legislative criteria.[8] As a result of the increase in cross-border attacks,[9] in 1956 the government introduced legislation providing compensation to civilians residing in or employed in frontier areas.[10]

The main problem with the 1956 law was that it only applied to those injured in geographical proximity to the border. Following the Six-Day War in 1967, anti-Israeli terror expanded to the streets of centrally-located Israeli cities as well as to Israeli establishments abroad and to Israelis visiting abroad. As a direct result of the change in reality,[11] the government introduced the Victims of Hostile Actions (Pensions) Law, 1970,[12] a more comprehensive compensation scheme, which, as amended, remains the basis of current law.

During the Knesset's deliberation on VHAPL, it was decided to equate the benefits given to injured civilians and to the families of victims of war or terrorism with the benefits provided to injured soldiers and to the families of soldiers killed in action, respectively. With that law, as amended over the years,[13] a comprehensive scheme was enacted that provides compensation for security-related harm caused to civilians.

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7. War Damage Compensation Tax Law, 1951, 5 L.S.I. 33, (1950-51).

8. Statement of the Minister of Justice, Pinchas Rosen, when introducing the Border Victims (Benefits) Law, D.K. (1956) 32.

9. Between 1949 and 1956, 434 citizens were killed by cross-border attacks. Statement of Knesset's Labor Committee Chairman, M.K. Akiva Guvrin, D.K (1956) 440.

10. Border Victims (Benefits) Law, 1956, 11 L.S.I. 19, (1956-57).

11. "Existing law was fit to the security situation of that time, when hostile acts harmed mostly residents of border areas . . . but now, that frontier has widened to other areas of the country and it had even expanded beyond state borders." Statement of the Minister of Labor, Yossef Almogi, when introducing VHAPL, D.K. (1969) 284-85.

12. *See supra* note 2 and accompanying text.

13. Most amendments over the years served to further equate the benefits to civilian victims with those of injured soldiers and the families of soldiers killed in action. For example, a 2000 amendment provided reimbursement for money spent on maintenance of the grave of a victim of hostile act, since the graves of soldiers killed in action are maintained by the Ministry of Defense. Explanatory Notes, Draft bill amending VHAPL (no. 18) (Refund of Expenses for Maintenance of Grave), 2000 H.H., 314.

B. The Rationale for Compensation by the Government

When the first compensation was enacted in 1951,[14] the rationale behind it was clear. As put by the Knesset's (Israel's Parliament) Finance Committee Chairman, M.K. David Pinkas, "It is inconceivable that the damage from this war which we had to withstand will be borne by individuals and not by the whole public."[15]

Interestingly, the same principle had led then British Prime Minister Winston S. Churchill to determine, during the German Blitz against England in World War II, that it was "unfair for British society to place the entire burden of the destruction on those unlucky enough to be hit."[16] Churchill thus ordered:

> that all damage from the fire of the enemy must be a charge upon the State and compensation be paid in full and at once. Thus the burden would not fall alone on those whose homes or business premises were hit, but would be borne evenly on the shoulders of the nation.[17]

The risk-spreading policy applicable to war holds true with respect to terrorism to an even greater degree. In most cases of war, the burden of casualties is borne by members of the military. Most countries provide benefits to the victims of their armed forces and their families.

Terrorism, however, is a type of war in which the enemy, the terrorist organization, selects random civilians as its target. In the war declared by terrorist organizations, civilians are drafted involuntarily by the cruel decision of the enemy. They are hurt solely for being citizens of a certain country or visitors to that country. The rationale of providing compensation to those civilians may be viewed as an extension of customary compensation of members of the armed forces.

A compensation scheme against terrorism damage may also be viewed as a result of the state's duty to protect its citizens against terrorism. If that duty is viewed as absolute, the state would have to compensate its citizens. Traditional economic analysis of tort law, which looks for ways by which the victim could have minimized the risk of losses, can be applied only in a limited way in terrorism cases. That analysis is hard to apply to innocent airline passengers or World Trade Center employees who were murdered on 9/11. Leon Klinghoffer, the disabled sixty-nine-year-old American who was brutally murdered by terrorists in 1985, merely took a cruise on the *Achille Lauro*, where he met his killers.

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14. *See supra* note 7.

15. D.K (1951) 983.

16. As described in Green v. Smith & Nephew AHP, Inc, 617 N.W.2d 881, 888 n.3 (Wis. Ct. App. 2000), *aff'd*, 629 N.W.2d 727 (Wis. 2001).

17. WINSTON S. CHURCHILL, THEIR FINEST HOUR 349 (1949). I am indebted to Marshall S. Shapo, who brought this Churchill quote to my attention in his paper published in this issue of the INDIANA LAW REVIEW. Marshall S. Shapo, *Compensation for Victims of Terror: A Specialized Jurisprudence of Injury*, 36 IND. L. REV. 237 (2003).

In Israel, where every restaurant and bus has become a potential frontline in terror's war, the rationale of viewing the civilian victims of terrorism as involuntary soldiers has been taken even further. As mentioned above, under current law, the benefits provided to those wounded in terrorist attacks and the families of those killed in terrorist attacks have been equated to the benefits provided to injured soldiers and to the families of soldiers killed in action.

C. What is Terrorism? (or: When in Doubt, It Must be Terrorism)

Current Israeli law makes no distinction between civilians harmed by war and civilians harmed by terrorism. Both situations are now part of the definition of an "enemy-inflicted injury," the central term of VHAPL. An "enemy-inflicted injury" is defined by that law as any of the following:

> (1) [A]n injury caused through hostile action by military or semi-military or irregular forces of a state hostile to Israel, through hostile action by an organi[z]ation hostile to Israel or through hostile action carried out in aid of one of these or upon its instructions, on its behalf or to further its aims ([A]ll hereinafter referred to as "[E]nemy [F]orces");
> (2) [A]n injury inflicted by a person unintentionally in consequence of hostile action by [E]nemy [F]orces or an injury inflicted unintentionally under circumstances in which there were reasonable grounds for apprehending that hostile action as aforesaid would be carried out;
> (3) [A]n injury caused through arms which were intended for hostile action by [E]nemy [F]orces, or an injury caused through arms which were intended to counter such action [excluding an injury inflicted upon a person age 18 or older while committing a crime, or a felony involving willfulness or culpable negligence].[18]

The definition quoted above is quite far-reaching.[19] It encompasses not only harm inflicted by a terrorist act, but also harm caused by defensive measures aimed against terrorist aggression. "Friendly fire" is hence covered, as is the accidental explosion of ammunition stocked in anticipation of terrorist attacks.[20] The required nexus is defense from hostile acts in general, rather than a specific, clear, and present attack. The nexus needs to be a real one, though. The Israeli Supreme Court held that "arms used for military training are not intended, at that time, to counter hostile acts, whereas a mine laid near the border does serve that purpose."[21]

The determination as to whether an event constitutes a "hostile act" is made

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18. VHAPL, 24 L.S.I. 131, (1969-70).

19. For obvious reasons, the law does not apply to a person belonging to enemy forces, aiding them, or acting as their agent or on their behalf or in order to further their interests.

20. *See, e.g.*, H.C. 92/83, Nagar v. Nat'l Ins. Inst. ("NII"), 39(1) P.D. 341 (holding that children wounded by playing with ammunition found at a dumpster near a military compound were victims of a hostile act).

21. H.C. 294/89, NII v. Appeals Committee, 45(5) P.D. 445.

by an "approving authority" appointed by the Minister of Defense.[22] In many situations, the classification is not entirely clear, and an event may be viewed as either a criminal act or a terrorist act.[23] For example, a terrorist may decide to attack a person whom they know and with when they have a previous relationship, such as an employer, a lover, or a co-criminal. The victim, or in case of death—his relatives, have a vested interest in having the event declared a "hostile act." Not only would such classification provide significant monetary compensation,[24] it would also carry a deeper meaning: the victim will be viewed by friends, family, and society at large as an innocent victim of political aggression—a martyr—rather than a mere crime victim whose own actions may have led to the attack. It should be noted that the offender, if caught, may also obtain advantages by characterizing the event as terror-motivated, rather than criminal.[25]

The VHAPL provides the following rebuttable presumption: "Where a person has been injured under circumstances affording reasonable grounds for believing that he has sustained an enemy-inflicted injury, the injury shall be regarded as enemy-inflicted unless the contrary is proved."[26]

The case of *Coca v. the Approving Authority*[27] may serve to illustrate the borderline situations. In *Coca*, the parents of a Jewish murder victim appealed the decision of the Authority to deny "hostile act" status of their son's murder by a Palestinian male prostitute. The murderer had given conflicting reasons for the crime, ranging from criminal (theft) to nationalist. The Court held that the event was a hostile act based on the fact that the murderer took no money or valuables

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22. The decision may be appealed to an Appeals Committee (VHAPL, Article 11). Although the law attempted to provide that the decision of the Appeals Committee is final, the Supreme Court held that the decision was subject to judicial review by the court system. *Id.*

23. The classification problem is somewhat similar to the classification of hate-motivated crimes in the United States. *See, e.g.* Elizabeth A. Boyd et al., *"Motivated by Hatred or Prejudice": Categorization of Hate-motivated Crimes in Two Police Divisions*, 30 LAW & SOC'Y REV. 819 (1996); Frederick M. Lawrence, *The Punishment of Hate: Toward a Normative Theory of Bias-Motivated Crime*, 93 MICH. L. REV. 320 (1994); James Morsch, *The Problem of Motive in Hate Crimes: The Argument Against Presumptions of Racial Motivation*, 82 J. CRIM. L. & CRIMINOLOGY 659 (1991).

24. Generally, victims of criminal action are not eligible for any state financial support. In March 2001, the Knesset (Israeli Parliament) enacted the country's first legislation for crime victims, the Crime Victims' Rights Act, 2001, S.H. 183, providing for very limited non-monetary rights of victims. For a summary of the new law (in English), see http://www.victimology.nl/onlpub/national/il-lawyanay.doc.

25. Such advantages may include financial support for the offender's family by supporters of terrorism and the chance of being released as part of political agreements or hostage-taking situations. At least in the case of murder, there is no difference in the punishment of the offender, as Israeli law generally provides for a mandatory life sentence in any case of murder, regardless of whether the motive was criminal or terror.

26. VHAPL, 24 L.S.I. 131, (1969-70).

27. V.A. (T.A.) 4076/98, Coca v. Approving Authority, 32(10) Dinim-Dis. Ct. 485.

from the deceased's apartment, where the crime took place,[28] and on the cruelty of the murder.[29]

The *Coca* court encountered another legal hurdle: the assailant was not a member in any organized terrorist organization. The Court observes that under the law "[i]t is not enough that a person rises one clear morning [out of the blue] to kill another person out of nationalist motives to bring the murder within the framework of Hostile Action."[30]

The problem encountered by the court is that of the lone terrorist, who is not affiliated with any organization.[31] In order to overcome that hurdle, the court used a presumption, which appears to be stretching the law beyond its original intent. The Court first observed that one of the goals of terrorist organizations is the killing of Jews. Hence, the Court stated that, the murder of a Jew for a nationalist motive causes the promotion of the goals of terrorist organizations and may therefore be viewed as a hostile act.[32]

As demonstrated in the *Coca* case, courts are quite generous in expanding the definition of a hostile act. The courts' approach is in line with the legislative purpose and with the legislative language, creating a presumption which makes it easier to reach "hostile act" status. It should be noted, however, that this wide definition of a hostile act is very different from the narrow definition that the courts gave to the word "hostilities" appearing in exclusion clauses of insurance policies.[33]

The issue of Palestinian victims of Jewish terror[34] is relatively new.

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28. The assailant only stole the victim's car, which he used to escape, and a cellular phone.

29. The Court notes, to support this conclusion, only that the assailant stabbed the victim many times and caused deep wounds.

30. *Coca, supra* note 27, at 6.

31. The same problem gave rise to the differences between Israeli and American officials following the fatal shooting attack at the El-Al ticket counter at Los Angeles International Airport on the Fourth of July, 2002. Israeli officials immediately referred to the event as "terrorism" while the FBI, not finding a link between the shooter and a terrorist organization, suggested the incident may have been a "hate crime." *See* Mark Matthews, *Airport Shooting Sharpens Debate on Defining Terror*, BALT. SUN, July 6, 2002, at 1A.

32. An event that does not qualify as Hostile Act may still give rise to a personal injury or wrongful death claim against the government. *See, e.g.*, C.A. 2352/97, The State of Israel v. Astiti, 55 Dinim-Sup. Ct. 145.

33. Jacob Potchebutzky, *Hamishim Shana—U'ma Nishtana? Al Pitsui Be-Gin Nizkey Milchama* [*Fifty Years—What Changed? (Compensation for War Damage)*], 13(2) MISSIM A-1 (1999). Although the observation was made in connection with compensation for property damage, it applies here as well. Potchebutzky quotes, for example, the British case of *Atlantic Mutual Insurance Co. v. The King*, 1 Eng. Rep. 30 (K.B. 1919): "The word 'hostilities' . . . means hostile acts by persons acting as the agents of [s]overeign [p]owers, or of such organized and considerable forces as . . . mobs or rioters, and does not cover the act of a mere private individual acting entirely on his own initiative, however hostile his action may be."

34. Palestinian victims of Palestinian terror are covered just like Israeli victims of Palestinian terror, provided they are Israeli residents or entered Israel legally.

Following a test-case law suit by a Palestinian attorney working with the Israeli Association for Civil Rights, the government chose to settle the case rather than have it decided by the court.[35] The settlement requires that a solution be devised for similar cases, and the Attorney General has ruled that Palestinian victims of Jewish terrorism deserve equal treatment even if the language of the law does not seem to address that issue.

D. Who Is Covered

Initially, the main purpose of the compensation schemes was to cover Israeli citizens and residents. Since Israelis have been the target of terrorist attacks outside Israel, they are covered both in Israel and while abroad.

The compensation schemes were extended to cover certain foreign nationals who may become victims by reason of their association with Israel or Israeli entities. Thus, the law covers all foreign nationals harmed by a hostile act while in Israel or in the Territories administered by Israel[36] provided that they entered Israel legally. That coverage extends, *inter alia*, to tourists, business travelers, and legal foreign workers.

Illegal foreign workers are generally not considered covered by the law, although a legislative glitch may have created a loophole.[37] The terror acts accompanying the Palestinian uprising, which started in September 2000, found Israel at a point during which tens of thousands of illegal foreign workers resided in the country. Since many terror attacks were directed at public transportation, illegal foreign workers were wounded on several occasions. They received medical treatment and humanitarian aid, but were not considered entitled to the full financial benefits under the law.[38]

Another class of foreign nationals exposed to anti-Israeli terrorist attacks are employees of Israeli entities abroad. Not all employees of Israeli companies are covered; only those employed by the state of Israel (embassies, consulates, and other formal delegations representing the state) or by an employer pre-approved for that purpose by the Minister of Labor. The Minister of Labor has to date approved thirty-three employers, consisting mainly of banks, Zionist organizations, airlines, media, and shipping companies.

An attempt to apply the same analysis to the United States may prove quite difficult. Anti-American sentiment often takes the form of attacking American-

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35. For a description of the test case and the ensuing settlement, see http://www.phrmg.org/monitor2000/apr2000-toward.htm.

36. The areas known as Judea, Samaria, and the Gaza Strip.

37. The law applies to a person "who *entered* Israel based on a visa or permit" (emphasis supplied) and does not provide that those who stay beyond the period permitted in their visa or those who enter under a tourist visa and accept employment are ineligible. VHAPL, 24 L.S.I. 131, (1969-70). Hence, the language of the law appears to cover foreign workers who entered the country on a valid visa but not to cover those who entered the country illegally.

38. In recent years, the NII has provided illegal foreign workers with all benefits under the law ex gracia.

owned fast-food restaurants overseas.[39] Would an attack on a McDonald's restaurant, certainly inspired by anti-American sentiment, qualify as terrorism?

The inclusion of foreign nationals provides a layer of protection, which, in many cases, acts to replace partially acts-of-war or terrorism exclusions under private insurance policies. Although the coverage under Israeli law does not overlap with the individualized privately acquired policies, it does provide a safety net for the cases where other means of compensation are excluded. It is unclear if the existence of government insurance would influence individuals considering visiting Israel.[40] It appears, however, that institutional tours (such as support groups by synagogues) are easier to organize when the inability to purchase commercial travel insurance is compensated for by the government insurance.

E. Compensation for Injured Victims

Victims who are injured by a hostile act are entitled to medical care and to a stipend while receiving medical care. Those who remain permanently disabled are entitled to disability benefits. All benefits under VHAPL are administered by the National Insurance Institute ("NII"), which is the equivalent of the Social Security Administration in the United States.

1. Medical Care.—Injured victims are entitled to state-funded medical care. Medical care is defined widely to include hospitalization, clinic visits, dental care, medicines, medical devices, medical care-related travel expenses, medical rehabilitation and recuperation. Although Israel has a national medical insurance plan, the benefits provided under the law exceed the benefits under the national insurance.[41]

Foreign residents injured in a hostile act while in Israel and then returning to their own country may receive the necessary medical care at the expense of the Israeli government unless they receive the medical care from the country in

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39. *See, e.g.*, http://www.cnn.com/2001/WORLD/asiapcf/southeast/10/11/ret.indon.protests/; *see also* http://www.cnn.com/2000/WORLD/asiapcf/southeast/10/12/ret.indonesia.protests/ index.html.

40. While the Israeli governmental insurance company announced it was creating a special life insurance policy to cover business visitors, the head of a commercial insurance company said that his company continuously offered the coverage, but that there was very little demand for that special insurance ("Our feeling is that the insurance issue is just an excuse for those who are not interested to arrive to Israel"). Elazar Levin, *Clal Insurance: There is No Reason for the Cancellation of the Gertner Conference; Americans May be Insured in Israel*, GLOBES, Apr. 15, 2002, at 3; Shlomi Sheffer, *Inbal's CEO: The Tourist Insurance Plan Will Accommodate Business People*, HAARETZ, Apr. 15, 2002, at C7.

41. Examples of such wider coverage include covering dental expenses (not covered in the national medical insurance plan), and the waiver of all deductibles and co-payments provided for in the national medical insurance plan. The detailed description of the various benefits as described in footnotes 41-100 and accompanying text was compiled by the author from a variety of formal and mostly informal sources.

which they reside. The coverage will even include an increase in medical insurance premiums paid to the victim because of the deterioration of his health due to the hostile act.

2. Living Stipend While Receiving Medical Care.—An injured victim who is unable to work while receiving medical treatment is entitled to a stipend during that period, provided he is not collecting his salary,[42] or in the case of a self employed individual, if he stops working.

The stipend is based on the victim's pre-injury income,[43] subject to a limit set at a rate of five times the average salary in Israel.[44] Victims who are unemployed at the time of the injury receive a stipend based on the (relatively low) salaries of mid-level government employees, factoring in their age and family situation.[45]

The living stipend during medical treatment is provided for an unlimited amount of time as long as the victim is unable to work because of the medical treatment.

3. Disability Compensation.—An independent medical committee determines whether the victim is temporarily[46] or permanently disabled, and at what rate (expressed as a percentage of disability).[47]

Victims judged to be 20% or more disabled qualify for monthly disability benefits. The amount of compensation is calculated by multiplying the rate of disability by 105.1% of the salary of a low-level government employee. A 40% increase is paid to victims of specific and very severe types of disability.[48]

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42. Employers who continue to pay the victim's salary while the victim is unfit to work may be eligible for a refund of the wages paid by them.

43. The pre-injury income is determined by the average income of the victim for the three months preceding the injury.

44. The ceiling of five times the average wage is the same used for other social security benefits.

45. A single victim with no children under eighteen receives a stipend equal to 65.025% of the salary of the applicable government employee. A married victim with no children under the age of eighteen receives a stipend equal to 86.7% of the salary of the applicable government employee. Victims with one or more child under eighteen receive a stipend equal to 112.4% of the salary of the applicable government employee. The stipend for the unemployed also serves as the floor for determining the amount of the stipend to lower-income employees.

Children under fourteen years of age are not entitled to a stipend during the period of medical care but they are entitled to other benefits accorded to victims. Victims who are between the ages of fourteen to eighteen and who were not regularly employed before their injury are entitled to compensation at the rate of half the amount paid to an unemployed victim. Minors between the ages of fourteen to eighteen who were regularly employed receive compensation similar to that of employed adults.

46. Temporary determinations are made, where appropriate, for a period of no more than one year.

47. The detailed method of determining the level of disability is beyond the scope of this paper.

48. The increase applies to: a person completely paralyzed in the lower half of their body; a

Victims who are, or who become, fifty-five years old or older, are paid an age-based supplement.[49]

Victims rated between 10% and 19% permanently disabled are given a one-time disability grant rather than monthly benefits.[50] Disability benefits are paid regardless of any other sources of income the victim may have. There are, however, several categories of victims with little or no additional income, who may be eligible for additional benefits. Thus, some victims may be classified as "needy disabled"[51] and receive significantly higher benefits, based on their level of disability, family situation, and other sources of income.[52] Similar benefits are paid to victims who, because of the irreversible physical or mental disability suffered as a result of the hostile act, have permanently lost their ability to earn a living. In certain cases, a short-term unemployment supplement[53] and an early retirement supplement[54] are also available.

When a disabled person dies and the death is not considered to be as a result of the injury,[55] the NII continues to pay the disability benefits to the victims'

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person with two lower or upper amputated extremities; a person who is completely blind in both eyes; or a person suffering from extreme burns. The medical committee must approve the increase.

49. Men between fifty-five and sixty-five years old and women between fifty-five and sixty years old, who are at least 50% disabled, receive an age-based supplement ranging from 7% to 21% of the benefit paid to a 100% disabled victim. Men who reach the age of sixty-five and women who reach the age of sixty are eligible for a 10% increase, but may no longer apply for unemployment benefits. *See infra* note 53.

50. The amount of the one-time grant is calculated by multiplying (1) the level of disability by (2) 105.1% of the salary of a low-level government employee, and then by (3) the number of months the grant will cover ranging from 108 months for 10% disability to 215 months for 19% disability. Special provisions apply if the situation of the victim deteriorates and he is later considered disabled at a rate of 20% or more.

51. A "needy disabled" person is a person with a 50% or more level of disability whose income from all sources is below a set level of income (set at the rate of a disability benefit for a 100% disabled person).

52. A "needy disabled" victim with no children under twenty-one receives a benefit equal to 124.4% of the salary of a mid-level government employee. Victims with one child or more under the age of twenty-one receive a benefit equal to 138.2% of the salary of the applicable government employee. Victims with a 60% or more level or disability get a 5% to 20% increase based on their level of disability. Income from all sources earned by the recipient is deducted from the benefit. Eligibility for Needy Disabled status is reassessed annually.

53. The victim must meet an income test and prove that he has attempted to obtain employment and that he has not rejected any employment offers.

54. Early retirement supplement is given to victims with a 50% or more level of disability who are between the ages of fifty and sixty-four, who retire from their employment for medical reasons, are no longer suitable for employment, are limited in movement as a result of the injury, and meet a certain income test.

55. When the death is a result of the injury, the family members of the victim are entitled to benefits as relatives of a deceased victim. *See* discussion *infra*, Part I.F.

heirs for three additional years after the death,[56] and in certain cases, makes additional payment to dependents.[57]

4. Additional Monetary Benefits.—The law provides for a host of additional benefits, each with its own criteria and limitations. The most important among them are: the care-taking benefit;[58] home purchasing grants and loans;[59] financial assistance in the purchase of a medically necessary car;[60] monthly mobility payments;[61] appliances, special equipment and other household items to paraplegics[62] and the blind;[63] a yearly clothing allowance;[64] a heating or cooling

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56. The compensation payment is paid to the family member indicated in writing by the victim before his death, and where no such instruction was given, to the spouse, if there is one, or in the absence of a spouse, to another family member determined by the NII.

57. *E.g.*, the payment of the care-taking benefit, described in *infra* note 58, continues for three years after the death; a portion of the payment for Needy Disabled, described in *supra* note 51, is paid to a surviving spouse who has no independent income and as long as the spouse does not remarry; where the victim was not survived by a spouse but was survived by a child, the child will be paid the benefit paid to bereaved children until he reaches maturity, even though the death is not as a result of the injury.

58. Victims with a level of disability of 40% (25% for a woman with her own independent household) or more may be eligible. There is a complex point system for determining the payment for care taking based on the level of disability, family situation (a single victim is entitled to a higher payment than a married victim; a single parent of children less than fifteen years of age is entitled to increased payments; a victim who is or becomes pregnant receives an increase as of the sixth month of her pregnancy), and age (a married victim receives the higher payment given to single victims when his or her spouse reaches the age of forty).

59. The eligibility for this benefit is based on the type and severity of the injury and is granted to first-time homeowners and victims who need to replace their current apartment for a justified reason. The law also provides for real estate tax breaks.

60. Eligibility for this benefit is determined by the type and severity of the injury. The benefit includes a full waiver of the taxes on the car (in Israel, where cars are heavily taxed, that represents a discount of approximately 40% of the price), a grant in the amount of two-thirds of the pre-tax price of the car and a loan for the remaining one-third of the price, as well as a yearly allowance for insurance.

61. Eligibility for this benefit is determined by the type and severity of the injury. The mobility payments are intended to cover expenses involving rides to work, studies, sports practice or for any other reason. The amount of the benefit is based on the reimbursement paid to government employees for use of their private car.

62. These include a heating stove, refrigerator, two air conditioner units, and a remote system for opening the door. Depreciable assets include blankets, sheets, and sweats.

63. These include a Braille typewriter, a Braille watch, a cassette recorder, a stereo system, and two air conditioning units.

64. The eligibility for this benefit is based on the type and severity of the injury, as well as on the victim's gender.

grant;[65] yearly convalescence grants;[66] income tax[67] and national health tax breaks;[68] college education grants for children of the victim;[69] a marriage grant;[70] and telephone expenses.[71]

The immediate family members of the victim are entitled to reimbursement of their expenses[72] and loss of wages while the victim's medical situation requires the presence of a family member near his or her bed.

5. Rehabilitation.—Victims with no profession, or who need to change professions because of their injuries or because of other reasons, may be eligible for professional rehabilitation. Rehabilitation is given in one of three forms: vocational training, higher education, or rehabilitation in an independent business.

In vocational training and higher education, the victim's full tuition[73] will be paid. If the course of studies does not allow the victim to work during his studies, a subsistence allowance based on the victim's degree of disability and family situation is paid monthly.

Victims may opt to seek assistance for starting their own business. If they choose this route, they may be eligible for grants to purchase commercial equipment and loans in an amount that varies with the victim's degree of disability. The loan is conditional on the approval of a business plan that considers the victim's limitations.

F. Compensation for Relatives of Deceased Victims

VHAPL also provides benefits for families of victims killed as a result of

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65. The eligibility for this benefit is based on the type and severity of the injury, as well as on the climate at the victim's place of residence.

66. A convalescence grant is paid once a year in the range of three to fourteen days depending on the level of disability. In some cases, convalescence grants are also provided for a companion. The per diem amount is based on the equivalent payment to government employees in Israel.

67. The eligibility for this benefit is based on the severity of the injury. Victims who are 100% disabled or completely blind are exempt from income tax on actively earned income up to a fairly high ceiling, regardless of the cause of disability. Income Tax Ordinance (New Version), 1967, 1 L.S.I. 145, (1967).

68. This benefit is only available to severely harmed victims who are employed or in early retirement.

69. The grant covers 40% of the actual tuition paid, not to exceed 40% of the tuition at state universities. Victims who reside outside Israel may use the grant to pay for tuition abroad.

70. A one-time marriage grant is given to people who, after becoming disabled, get married or have a relationship with a common-law spouse formalized in a binding legal agreement. The amount of the grant is determined according to the level of disability. A victim who moves to an independent apartment but remains single is eligible to receive 70% of the marriage grant at that time and the remaining 30% if and when he gets married.

71. The eligibility for this benefit is based on the type and severity of the injury.

72. Covered expenses include travel expenses, lodging and meals.

73. Limited by the tuition paid in the state's universities.

Hostile Acts. The structure of benefits is based on the benefits paid to the families of soldiers who die during and as a result of active duty.[74]

1. Monthly Benefits for a Widower/Widow, Bereaved Children and Bereaved Parents.—Widowers, widows, bereaved children and bereaved parents of victims killed as a result of Hostile Acts are entitled to a regular monthly benefit. The amount of the benefit, expressed as a percentage of the salary of a low-level government employee, is determined according to the age of the widow/widower and whether he or she has children.[75] Since the amounts are linked to the wages of government employees, they are updated following labor agreements and the Israeli mandatory cost of living increases.

In some cases, the law provides for the State to pay the victim's divorcee the alimony she was entitled to receive from the deceased.[76] The issue of a widow (widower) remarrying received a significant amount of attention in recent years, given past policy that the widow would lose her benefits after remarriage.[77] Critics felt the regulation was preventing rehabilitation rather than encouraging it. Consequently, the law significantly shifted in favor of the widows to assure that the potential loss of benefits does not impede a widow from remarrying and building a new life. Therefore, under current law, although a widow who remarries is no longer entitled to the monthly benefits in her own right, she instead (1) receives a generous, non-refundable marriage grant;[78] (2) continues to receive benefits for her children until the children reach twenty-one;[79] and (3)

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74. VHAPL applies, *mutatis mutandis* the benefits provided in Fallen Soldiers Families Law (Pension and Rehabilitation), 1950, 4 L.S.I. 115, (1949-50).

75. A widow/widower with no children under twenty-one receives a benefit equal to 124.4% of the salary of a low-level government employee. A widow/widower with one child or more under the age of twenty-one receives a monthly benefit equal to 175.9% of the salary of the applicable government employee, and a supplement of 11% for each child under twenty-one beyond the first child. A widow/widower whose children are over the age of twenty-one receives a monthly benefit equal to 156.5% of the salary of the applicable government employee. Some of the benefit is phased out when the last child reaches twenty-four. A widow who is pregnant at the time of the decease receives a 33% increase during the last trimester of the pregnancy. A 10% increase is made when the widow/widower reaches the age of sixty.

76. This benefit applies only when the divorcee was older than forty years old at the time of death or when the divorcee is the mother of a bereaved child of the deceased. In addition, the amount of alimony must have been set either by written agreement or by a court order.

77. The public attention was focused on female widows of male soldiers killed in action, hence the female language in this paragraph. As explained above, widows or widowers of victims of hostile acts are linked to the benefit structure for relatives of soldiers killed in action. The law applies equally to widowers of victims.

78. The marriage grant is in an amount equal to sixty monthly payments. The grant is divided into two payments: the first at the time of the marriage, and the second after two years. The widow does not need to refund the grant if she divorces.

79. The monthly payment to the remarried widow with one eligible child is 91.4% of the salary of the applicable government employee, and for each additional eligible child, 24% of the salary of the applicable government employee.

may become re-entitled before the age of sixty-five years old to the same benefits she received before she remarried should she get divorced or widowed.

Bereaved parents are entitled to a regular monthly benefit, independently of whether or not there are a widow/widower and/or bereaved children. The amount of the benefit is expressed as a percentage of the salary of a low-level government employee and is determined according to the age and family situation of the bereaved parents.[80] A portion of the benefit is phased out if the bereaved parents have other income.[81] A bereaved child receives a marriage grant upon getting married or reaching the age of thirty without getting married.[82] A widow/widower who must reside in a nursing home or who wishes to live in an assisted living environment may receive partial or full funding of this arrangement in lieu of monthly benefits.[83]

Certain additional benefits are provided only to needy widow/widowers or bereaved parents, based on their income and the availability of other relatives to help.[84] Thus, the law serves as a safety net, under the assumption that the deceased son or spouse would have provided for these needs had he or she not died.

2. Burial and Mourning Expenses.—Burial expenses are reimbursed at cost (up to a ceiling) to the family member who paid for them. Burial expenses include death notices, transfer of the body, and a tombstone. Special provisions increase the reimbursements for a foreign citizen killed in Israel but buried abroad[85] or, alternatively, cover the expenses of bringing siblings, children, parents, widow or widower to participate in the funeral if the deceased is buried in Israel.[86]

A one-time grant for mourning expenses is paid to a widow/widower and

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80. The amount of benefit for a couple of bereaved parents with no income is 123.4% of the salary of the applicable government employee. Benefits for a single bereaved parent are equal to 99% of the salary of the applicable government employee. For each sibling of the deceased under the age of eighteen, an additional 10% is paid. Bereaved parents receive a 10% increase when one of them reaches the age of sixty-five (sixty for a bereaved mother with no spouse).

81. Certain social security benefits are excluded from the definition of income for that purpose.

82. The bereaved child may get an 80% advance of the marriage grant if he or purchases his or her own housing.

83. The rate of funding is determined by age and family situation.

84. This would include for example, expenses for caretaking for those requiring assistance due to a medical condition.

85. The additional expenses covered are as follows: transporting the body abroad, services rendered by the pathology institute, transporting the body to the airport, transporting the body by sea or air and the expenses associated with a person accompanying the body from the foreign country to the family's place of residence.

86. Covered expenses include round-trip travel and seven days in a four-star hotel. The NII may extend the length of the stay when the eligible party requests to be present at the placing of the tombstone or because of illness. Those staying with relatives or friends, rather than at a hotel, receive a per diem reimbursement at the same rate of those paid to civil servants in Israel.

bereaved parents. The grant is intended to help cover expenses involved in the mourning, but does not cover all expenses. Expenses associated with yearly memorial services at the cemetery, including transportation, are also reimbursed, as are expenses associated with acts intended to memorialize the deceased, such as a memorial book, memorial events, etc. Finally, the law provides a grant to allow a bereaved parent, widow or widower to purchase a grave site next to that of the victim.[87]

3. Additional Monetary Benefits.—The law provides a host of additional benefits, each with its own criteria and limitations. Among the most important are the funding of psychological assistance;[88] housing assistance;[89] financial assistance in the purchasing of a car;[90] yearly convalescence grants;[91] tax breaks;[92] school grants;[93] college grants;[94] grants and loans to start a business;[95] Bar-Mitzvah grants;[96] a variety of health-related expenses;[97] and telephone

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87. Under Israeli law, basic burial, including the grave site, is covered by social security. However, those who wish to choose or reserve their grave site must purchase it.

88. Those eligible include a widow/widower, bereaved children to age thirty, bereaved parents, and bereaved brothers to age of thirty. Eligibility is conditional on the assessment by the caseworker that such treatment may assist with the family member's emotional state or ability to function.

89. Bereaved parents and a widow/widower with children who are neither homeowners nor recipients of public housing may be entitled to financial assistance in renting an apartment for one year following the Hostile Act (extendable under certain conditions up to two additional years). Rental assistance for up to one year may also be given to those relocating for certain reasons, including emotional reasons.

90. Bereaved parents and widow/widower who has not remarried are eligible for this benefit provided they have a valid driver's license or, if they do not have a license, if there are special circumstances requiring the car and there is a family member who would drive the car for them. The benefit includes a yearly allowance for insurance. A widow/widower who is ineligible to purchase a car or who elects not to purchase one receives a special mobility payment instead.

91. A widow/widower and bereaved parents are entitled to an annual payment for eight days of convalescence based on the rate paid to civil servants in Israel. The per diem amount is based on the equivalent payment to government employees in Israel.

92. The benefit includes reimbursement of a portion of the national health tax and discounts or exemptions regarding certain real property taxes.

93. The benefit is paid from through the twelfth grade. In some cases, tutors are also funded.

94. The widow/widower is eligible for this benefit regardless of age. The children of the deceased are eligible provided they were not older than twenty-one on the day of the event and not older than thirty at the time of academic studies. The benefit can also be applied to vocational training. The benefit covers actual tuition paid, which may not exceed the tuition at state universities, and an additional sum for books.

95. The assistance may also be used to improve an existing business.

96. This grant is paid to bereaved children upon reaching the age of adulthood according to Jewish law, which is age twelve for girls and age thirteen for boys. The grant is paid regardless of religion.

97. For example, travel expenses to and from medical treatment, medical instruments and

expenses.[98]

G. Choice (not Exclusivity) of Remedy: Towards a Liberal Approach

A victim who has a claim under the VHAPL and who may have a separate personal injury claim for compensation under another law may choose between compensation and rights according to the VHAPL and compensation and rights according to the other law.[99] Hence, the law provides for a *choice* of remedy, rather than an *exclusivity* of remedy.[100]

Although at first glance the "carrot and stick" mechanism here is reminiscent of the one used in the U.S. Air Transportation Safety and System Stabilization Act,[101] there are major differences between the two schemes. First, under the U.S. scheme the barring of a personal injury lawsuit is limited only to the airlines and other specific defendants,[102] whereas the Israeli scheme prevents simultaneous recovery from any defendant.

Second, the choice under the Israeli scheme only applies to the actual *recovery* of damages under the two causes of action, rather than to the pursuing of both causes of action. The choice to accept state benefits under the VHAPL may be revoked by the victim, with the NII's consent, in order to recover better compensation in the alternative lawsuit.[103]

Until recently, the NII adopted a stringent policy, under which it would not allow the victim to pursue the alternative lawsuit and return the state benefits, except in very limited cases. The NII position was based on paternalistic considerations, believing that a one-time payment under a personal injury lawsuit may be less advantageous than the very generous, and permanent, safety net created by the Law.[104] In order to deter victims from pursuing the alternative route, the NII adopted the position that its approval is needed prior to filing the alternative lawsuit, and that such action would require returning all benefits and stopping the payment of benefits before the alternative lawsuit is settled. In

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medicines not covered by the national health insurance, medical emergency bracelets, and 50% of dental expenses.

98. The benefit covers 50% of telephone expenses.

99. A legislative glitch allowed the simultaneous recovery if the other cause of action related to a car accident. That loophole was closed after six years of existence. C.A. 579/83, Malka v. Ararat, 42(3) P.D. 650.

100. This approach is common in many worker's compensation statutes in the United States.

101. Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, 115 Stat. 230 (2001).

102. Originally the Act only limited lawsuits against the airlines, but later it was amended to include aircraft manufacturers, airport sponsors, persons with a property interest in the World Trade Center, and the city of New York. Aviation and Transportation Security Act, Pub. L. No. 107-71, 115 Stat. 597 (2001).

103. The victim then needs to refund the NII for all compensation payments, grants and other payments that he had received according to the law in present monetary terms.

104. *See, e.g.*, H.C. 92/83, Nagar v. NII, 39(1) P.D. 341.

1999, however, the Supreme Court held that the NII position was unconstitutional. The Supreme Court held that the NII approval is only necessary after the alternative lawsuit is pursued, and that the NII should generally agree to the victim's decision to return the benefits in exchange for the right to collect on the personal injury lawsuit.[105]

One of the main reasons for the difference is, of course, the difference in the main purpose of the legislation. The U.S. scheme was primarily intended, as even its name attest, to defend the two major airlines involved in the 9/11 events from lawsuits by victims and their families.[106] The Israeli scheme was primarily intended to compensate the victims, and in most cases, there are no feasible legal ways under Israeli law to recover personal injury damages from the assailants or third parties.

From a policy standpoint, it makes sense to allow the victims to recover for full damages, including, where applicable, punitive damages. From a practical standpoint, it became more feasible for victims to attempt to recover damages from assets identified as belonging to terrorist groups[107] or even from states who sponsor terrorism.[108]

H. Procedural Aspects

The Law prescribes relatively short statute of limitations periods for filing

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105. C.A. 1162/96, Weiss v. Mack, 53(2) P.D. 79.

106. The media reports are also clear that airline bailout, rather than compensating the victims, was the main purpose. *See, e.g.*, Lizette Alvarez, *A Nation Challenged: The Bailout; An Airline Bailout*, N.Y TIMES, Sep. 22, 2001, at A1; James D. Tussing & Stewart B. Herman, *Government Acts to Bail Out U.S. Airlines*, 226 N.Y.L.J. (2001). For a detailed description of the U.S. legislation, see Raymond L. Mariani, *The September 11th Victim Compensation Fund of 2001 and the Protection of the Airline Industry: A Bill for the American People*, 67 J. AIR L. & COM. 141 (2002).

107. The United States had frozen hundreds of millions of dollars believed to belong to Osama Bin Laden or the Taliban. Cathy Booth Thomas, *Osama Will Pay. This Time in Cash*, TIME, Oct. 22, 2001, at 22.

108. In the United States, civil lawsuits against terror-sponsoring states were made possible by the Antiterrorism and Effective Death Penalty Act of 1996, Pub. L. No. 104-132, 110 Stat. 1214 (1996). In *Estate of Flatow v. Islamic Republic of Iran*, 999 F. Supp. 1 (D.D.C. 1998), the estate of a terror victim was awarded a judgment of more than $227.5 million against the nation of Iran. In *Eisenfeld v. Islamic Republic of Iran*, 172 F. Supp. 2d 1 (D.D.C. 2000), the estates of two terror victims were awarded a judgment of more than $327 million against the nation of Iran. For an analysis of the efficacy and advisability of utilizing civil lawsuits in domestic courts as means to compensate victims of state-sponsored terrorism, see William P. Hoye, *Fighting Fire with . . . Mire? Civil Remedies and the New War on State-Sponsored Terrorism*, 12 DUKE J. COMP. & INT'L L. 105 (2002). Recently, a large group of 9/11 victims' families sued a series of defendants allegedly related or supporting Osama Bin Laden's group in a $16 trillion lawsuit. *See* CNN, *$116 Trillion Lawsuit Filed by 9/11 Families* (Aug. 16, 2002), *available at* http://www.cnn.com/2002/LAW/08/15/attacks.suit/index.html.

claims for bodily harm and death and for appealing the decisions of the NII. The claim for a living stipend during medical care must be presented within one year from the date of injury. Appeals against the decisions of the Medical Committee must be filed within thirty days from the time the decision is communicated to the victim.[109] Appeals against the decisions of the NII must be filed with the Labor Tribunal[110] within six months from the date of the appealed decision.

Legal aid is provided, subject to significant exceptions and conditions, to applicants whose claim was rejected by the NII. A 1997 amendment to the law authorized the establishment of a representative organization of victims, funded by a deduction from the monthly benefits paid under the law.[111]

II. COMPENSATION FOR PROPERTY DAMAGE

A. The Evolution of Compensation for Property Damaged by War and Terrorism: From Mutual Insurance to Government Benefits

As with damage for personal injury, the compensation of victims of terror for property damage is an extension of the compensation to civilians for war damage. A brief history of that compensation is therefore in order.

Prior to the establishment of the State of Israel, the area now known as Israel was part of the British mandate, and deeply affected by British law. Great Britain was one of the first nations to legislate compensation and mandatory insurance for war property damage,[112] and it legislated a limited mandatory insurance in its Palestine (Israel) mandate.[113] The Jewish organizations preparing for the establishment of the State of Israel followed their lead. A few weeks before the Declaration of Independence took place, the Jewish Agency, together with several trade unions, organized a voluntary insurance scheme against damage caused by war to civilian property. The fund, which had no binding power, was created for a limited period of two years. The scope of events covered by insurance covered terrorist actions.[114]

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109. That extremely short time period may be extended only under special circumstances, with the consent of the NII, and for no more than an additional thirty days.

110. The Labor Tribunal has jurisdiction over virtually all disputes of claimants against the NII. Appeals may only be based on issues of law, and the Tribunal will not decide factual issues.

111. Although the deduction of dues is not mandatory, it is done automatically from the benefits of all members who have not expressly requested otherwise.

112. The first British legislation appears to be the War Risk Insurance Act, 1939, which was followed by the Landlord and Tenant (War and Damage) Act, 1939, the War Damage Act, 1941, and the War Damage Act, 1943 to 1964. The British legislation followed the refusal of major insurance companies to insure war damage. The War Damage Acts were repealed by Statute Law (Repeals) Act, 1981.

113. War Risks Insurance Ordinance (No. 32), 1941, 1139 O.J. App. 1 89.

114. "War . . . hostile actions, quasi-war actions (whether a war has or has not been declared), civil war . . . uprising . . . civil riots . . . vandalism caused by people acting maliciously on behalf or for a political union." Bylaws of the fund, *quoted in* Potchebutzky, *supra* note 33, at A-3.

Following the end of the War of Independence, the Knesset legislated the Law of Tax for War Damage, 1951.[115] That law levied a tax (in essence, a compulsory insurance) on all business property and real property which could be damaged by war, and provided for compensation of the same assets. The regulations promulgated under the law broadened the definition of covered events beyond acts of war by including damage due to "other hostile actions."[116]

The main ideology behind the law was spreading the loss by means of compulsory insurance, since "the damage is not unique to a specific property owner who was unfortunate enough to be damaged by war or hostile acts."[117] The insurance theory had significant practical importance when it caused the Court to reject a regulation providing for contributory negligence by the victim as unreasonable and *ultra vires*.[118]

In 1961, Israel adopted the Property Tax and Compensation Fund Law, 1961,[119] (the "Compensation Law") consolidating and replacing several older laws. The law created a fund, originally funded by a corresponding property tax, to compensate victims of war or terrorist activities.[120] The Compensation Law and the regulations promulgated thereunder, are the basis of the current compensation system for property damage caused by war and terrorism.

Although the Compensation Law continued the practice of incorporating the compensation fund and property tax into the same law for the political purpose of justifying the tax as a type of insurance, only a small percentage of the property tax collected was actually used for the compensation fund. Over the years, and especially since 1981, the link between the assets subject to the property tax and the assets covered by the compensation provisions was completely detached, and the property tax was used, until repealed in 2001,[121] to achieve unrelated economic goals.[122] One interesting remaining result of the link between the tax and the compensation is that the compensation scheme is still administered by the income tax authorities, the equivalent of the U.S. Internal Revenue Service. Thus, the tax authorities take the role of helping hand, quite an unusual phenomenon.

Following Israel's involuntary participation in the Gulf War,[123] the issue of

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115. War Damage Compensation Tax Law, 1951, 5 L.S.I. 33, (1950-51).

116. Regulations Regarding Payment of Compensation, 1952, K.T. 256, 694.

117. Statement of Finance Minister Eliezer Kaplan when introducing the law. D.K. (1950) 854.

118. T.A. 71/91, Hassaot Perach Hamidbar v. Manager of Prop. Tax, 53 P.M. 492.

119. Property Tax and Compensation Fund Law, 1961, 15 L.S.I. 101, (1960-61).

120. The law also covers certain agricultural damages caused by drought.

121. The property tax was repealed for administrative reasons unrelated to the compensation fund.

122. Property tax was levied only on undeveloped land, with the hope of encouraging development and preventing the holding of undeveloped land by investors waiting for a rise in demand.

123. During the Gulf War in 1991, Iraq fired missiles at Israeli cities, causing significant property damage.

harm to civilian property arose again, and the compensation scheme was expanded to increase the amounts paid. The main increase was in setting the compensation for damage to household items[124] at full replacement value rather than at the depreciated value of the assets affected. Since the Regulations set certain quantity, value and total compensation limitations on the covered assets,[125] citizens were allowed to voluntarily insure their household items with the government authority up to far higher amounts. The voluntary insurance scheme does not apply to business property. Hence, the compensation scheme gradually shifted from compulsory mutual insurance, aimed primarily to operate in the vacuum created by the insurance companies' refusal to act, to a social support system funded by the general taxpaying public.

B. Damages Covered by the Compensation Law

The law covers "War Damage" (direct damage to property) and "Indirect Damage." Both terms are defined as to include terrorist acts as part of the expression "other hostile actions against Israel."[126]

Borderline situations, where it is hard to determine whether an event is a hostile event or a crime, exist in the case of property damage just as in the case of bodily injury, discussed above.[127] These have been the subject of much of the litigation surrounding the Compensation Act.[128] One difference, however, is that the Compensation Law does not provide a presumption similar to that of the VHAPL that borderline events would be considered as hostile acts.[129]

In 1998, the Israeli Supreme Court set some guidelines on what would constitute a hostile action in *Bekaot v. Manager of Property Tax*.[130] *Bekaot* involved the simple theft of an automobile from Israel into the Palestinian authority, where the car was "stripped" to be sold as car parts. It should be noted

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124. Household items include furniture, appliances, electronics, books, and similar items. Jewelry, art, antiques and cash are not covered.

125. The Property Tax and Compensation Fund Regulations (Payment of Compensation) (Household Items), 1973, K.T. 3045, 1757 as amended, provide that compensation will be paid based on a replacement cost of the assets up to a prescribed maximum amount for each category of items of personal belongings (furniture, clothing, electronics, other domestic items).

126. War Damage is defined as "[d]amage caused to assets from actions of war by the enemy's regular army, or from other hostile actions against Israel, or from actions of war by the Israeli Army." Indirect Damage is defined as follows:

> A loss, or the loss of earnings, as a result of war damage in a border settlement or from the inability to use assets located in border settlements as a result of actions of war by the enemy's regular army, or from other hostile actions against Israel, or from actions of war by the Israeli Army.

127. *See supra* notes 27-33 and accompanying text.

128. *See* Potchebutzky, *supra* note 33, at A-5; T.A. 381/97 *Gilad Spices Ltd. v. Manager of Property Tax*, 32(1) Dinim-Dis. Ct. 574.

129. *See supra* note 26 and accompanying text; *see also* VHAPL, 24 L.S.I. 131, (1969-70).

130. C.A. 6904/97, S.T.V. Bekaot v. Manager of Prop. Tax, 53(4) P.D. 1.

that, at the time, a very high percentage of all stolen cars in Israel were taken to Palestinian "car slaughterhouses." Claimant, the corporation which owned the stolen car, produced a formal police document stating that Palestinian car thieves should be viewed as activists in the Palestinian anti-occupation "uprising," and claimed that it was accordingly entitled to compensation for damage caused by a hostile act.

The Supreme Court held that theft may be considered property damage, but that is not enough to be compensated under the law. A claimant under the law must also prove a "motive of hostility," in order for the hostility to be interpreted as against the State of Israel. The hostility can be the result of revenge for an act by the Israeli government, or an act with the goal of frightening the citizens of Israel, or an intent to affect Israel's future actions. In all of these cases, the Supreme Court held that the claimant must prove that the Israeli identity or nexus was the justification for causing the damage to the property.[131] In this case, there was no such evidence, and the claim was rejected.

Direct damage to property is covered in accordance with the Property Tax and Compensation Fund Regulations (Payment of Compensation) (War Damage and Indirect Damage), 1973,[132] promulgated under the law. Under the regulations, the compensation is limited to the "Real Damage," defined as the lower amount of: (i) the difference between the value of the asset before the damage occurred and the market value of the asset immediately after the damage occurred; or (ii) the cost of restoring the asset to its prior condition.[133] In addition, compensation will be paid for reasonable expenses incurred during the occurrence of the damage and aimed at mitigating the damage.[134]

Although the law calls for compensation to be made by way of reimbursement, the practice in terrorist acts affecting many victims (such as bombs exploding in commercial areas) has been for the Tax Authority to send loss adjusters and hire contractors to fix the damage of all the businesses involved. In other cases, the owner of the property hires contractors who are paid directly by the Tax Authority.

The system described significantly reduces the amount of time it takes for life to return to normal following a terrorist attack. In the absence of the compensation scheme, one may assume that some business owners would be insured (assuming insurance against terrorist acts is available) while others would not. One can also assume that estimators from different insurance carriers may disagree on their respective share and accordingly take their time in issuing compensation. Contractors working for different employers may also conflict with each other. As one of the goals of the Israeli government is to return life to normal as quickly as possible following a terrorist attack, it appears that the scheme provides a rather effective means to achieve that goal.

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131. *Id.*

132. K.T. 3039, 1682.

133. *Id.* § 1.

134. For example, the hiring of security guards to prevent looting would be covered in certain situations.

Indirect damage, including business interruption and loss of earnings, is usually not compensated, except for those damages sustained by businesses in border settlements.[135] Where applicable, indirect loss is computed in accordance with a detailed set of rules that attempt to cover the real economic loss.[136]

In 2001, with the beginning of the current wave of hostilities, the Compensation Law was amended to allow the government to compensate for indirect damages caused by hostile acts. Compensation is now available provided that: (I) the damage was caused by actions which the Minister of Defense declared as hostile actions; and, (ii) the damage occurred in a location which the Minister of Finance, with the approval of the Knesset's Finance Committee, declared as an area damaged by hostile actions. When both conditions are met, the law authorizes the payment of compensation for damage to assets, loss of earnings, or the inability to use assets located in the affected area.

Until now, no appropriate declarations were made, nor were new regulations issued under the amended law. The Compensation Law thus remains, for now, a legal tool enabling the Government, if it elects to do so, to compensate for indirect damage under the existing scheme. Special rules apply to compensation for damage to Israeli-owned assets located out of Israel[137] and to Israeli-owned oil tankers.[138]

The Regulations provide that in the event an owner of property is entitled to receive compensation for the damage from the Tax Authority as well as another source, such as an insurance company, the compensation paid by the Tax Authority will only cover the difference between the amount received from the other source and the amount of damage.

C. Economic Losses Not Covered by Any Compensation Scheme

Although Israel has one of the most generous terror-compensation schemes in the world, terror causes economic harm that is currently not compensated by the government, or for that matter, by any other entity. The economic damage to the Israeli GNP resulting from terror events between September 2000 and March 2002 has been estimated by the Israeli government at NIS 24 billion

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135. The Finance Minister may declare towns as "border settlements," with the approval of the Knesset's Finance Committee. The Finance Minister has issued a list of towns and villages considered border settlements, and which is updated from time to time. Since the classification as border settlement carries potential economic benefits, the inclusion in the list may be the subject of political decision-making.

136. Property Tax and Compensation Fund Regulations (Payment of Compensation) (War Damage and Indirect Damage), 1973, *supra* note 132.

137. Property Tax and Compensation Fund Regulations (Payment of Compensation) (Israeli Foreign Assets), 1982, K.T. 4338, 882.

138. Property Tax and Compensation Fund Regulations (Payment of Compensation for War Damage) (Tankers), 1970, K.T. 2639, 209.

(approximately $5.1 billion U.S. dollars).[139] A survey by Israel's leading business daily found that 46% of respondents were affected economically by the recent unrest.[140] The endless wave of suicide bombers in 2001-2002 reduced business in main urban shopping areas by as much as 80%,[141] while at the same time increasing the business' expenses.[142] The highly developed tourism industry suffered substantial damage as a result of tourists' fear of terror.

Currently, the significant economic damage previously described is not covered under any compensation scheme. Although trade unions are pressuring the government to compensate business owners for these losses, thus far a general compensation scheme has not been devised.[143]

The lack of a unified compensation policy means that regulated industries may obtain concessions from their regulators only on a case-by-case basis. A striking example is that of the operators of commercial television, which in Israel is a heavily regulated industry subject to stringent requirements in producing expensive Hebrew language programming. As those operators have lost millions by being forced to abort regular programming in order to broadcast breaking news of terrorist attacks and because the operators could not broadcast commercials during the news broadcasts,[144] the regulators are now considering significant reductions based on the operators' commitment for original production of television, thus reducing the operators' expenses and ensuing losses.[145]

If the regulatory concessions go forward, unlike most other business entities the television operators would not only be able to fully recoup all of their losses from the recent waves of terrorism, but they would in essence, simply pass the burden to the actors, directors, and producers who are supposed to benefit from the mandatory requirements to invest in local television production. The fairness of such measure is questionable, but in the absence of a general compensation scheme, each business is left to fend for itself and can be expected to pull every string with the regulators.

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139. Zeev Klein, *Treasury Conducts Discussions on Damages From Conflict: Loss of GNP so Far – NIS 24 Billion*, GLOBES, Mar. 6, 2002, at 2.

140. Eliyahu Hassin, *46%—Terror Has Hurt Me Economically*, GLOBES, Mar. 17, 2002, *available at* http://www.schwarufglaw.georgetown.edu.

141. Sapir Peretz, *Ghost Street*, GLOBES, Jan. 28, 2002, at 3.

142. For example, most restaurants in Israel have employed, since 2001, armed guards. *See* Sapir Peretz, *Retailers: Financing Security Staff Will Worsen Our Situation*, GLOBES, Apr. 1, 2002, at 3.

143. *See, e.g.*, Sharon Kedmi, *Chamber of Self Employed Organizations: Subsidize Anti-Terror Defense Measures*, GLOBES, Mar. 18, 2002, at 31.

144. Commercials are not broadcast either because of regulation prohibiting commercial breaks during such broadcasts (in most cases) or because of advertisers pulling their commercials out of tragic television programming.

145. *See, e.g.*, Ori Ayalon, *Channel 2 Licensees Ask that the Expenses of Covering Terrorism Attacks be Recognized as Broadcasting Expenses*, HA'ARETZ, Apr. 11, 2002, *available at* http://www.haaretz.co.il.

III. THE ADVANTAGES AND DISADVANTAGES OF A PERMANENT COMPENSATION SYSTEM

A. Comparing the Incomparable

The United States had not provided federal support for compensation to victims of terrorism until the tragedy of September 11, 2001. As noted above,[146] the compensation scheme put in place after 9/11 was primarily aimed to protect the airlines involved in the attacks from potentially-devastating law suits. The scheme was specifically designed as an ad hoc action and does not appear likely, at least at the time of this paper, to turn into a permanent federal compensation scheme for victims of terrorism.

One may assume, however, that the issue of compensation will reappear, at least on an ad hoc basis, if and when terror strikes the United States again. According to one commentator, "Congress passes terrorism legislation in response to individual episodes of terrorism. Lawmakers working to pass legislation in the emotional aftermath of a terrorist event are not necessarily concerned with how, or even whether these laws coordinate with other similar laws."[147]

This part of the paper attempts to provide an analysis of a permanent system of compensation, such as the Israeli system described, and the ad hoc approach taken so far by the United States.

Two main differences should be noted before any comparison is even attempted. First, Israel has experienced significant waves of hostile actions over an extended period of time, while the United States civilian population has, to date, been the target of far fewer terrorist attacks. Sadly, the number of casualties in the United States has been extremely high in some of the events and the effect on certain segments of the economy, such as the airline industry, has been significant.[148] Yet, those were isolated events. Unlike Israel, the United States has not had to deal with frequent terrorist attacks which disrupt every aspect of daily life and significantly threaten all parts of the population for extended periods of time. The difference in frequency and spread of the risks associated with terror is quite significant. An American does not ask herself daily whether or not it is safe to go the mall or to a restaurant; an Israeli does.

Second, a permanent system aimed at compensating terror victims must be viewed in the context of the general welfare policy of the society involved. Israel

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146. *See supra* note 106 and accompanying text.

147. Deborah M. Mostaghel, *Wrong Place, Wrong Time, Unfair Treatment? Aid to Victims of Terrorist Attacks*, 40 BRANDEIS L.J. 83, 83 (2001).

148. Examples include the thousands killed in the September 11, 2001 events, the bombing of Pan-Am Flight 103 in 1988 (270 were killed), *see* Theresa Agovino, *Pan Am 103: The Next Step*, *at* http://www.lexisone.com/news/nlibrary/b021401F.html, and the Oklahoma City attack in 1995 (168 victims were killed), *see* Lois Romano, *Oklahoma City Unveils Design for Memorial to Bomb Victims*, WASH. POST, July 2, 1997, at 1.

has an extensive welfare system, providing generous state support (many people would say too generous) to large populations that would not otherwise receive the same benefits in the United States.[149] Clearly the willingness of the government to provide financial support and the public opinion as to the "entitlement" of terror victims to public support must be evaluated against that yardstick.

B. Advantages of a Permanent System

1. Equity Considerations.—The first and most intriguing problem in the American scheme of case-by-case legislation is the evident inequality between victims similarly situated. The issue has been raised regarding the compensation fund set by the U.S. Air Transportation and Safety and System Stabilization Act to compensate the 9/11 victims. While that compensation scheme provided an average award of $1.65 million to families of those killed on 9/11,[150] the families of victims of past terrorist attacks have received nothing.

The generous 9/11 victim compensation fund was made possible for two main reasons, those being the desire to bail the airlines out[151] and the horrible magnitude of the events. The public was much more open to the idea of a compensation fund for thousands of victims than it was when terrorism hit only a small number of victims.

If we are to accept a rationale that the society, rather that the individual innocent victim, should bear some of the cost of the terrorist attack, this rationale should apply to all victims of terrorism, regardless of the number of victims in a specific attack, and regardless of the external motive to bail out the airline industry.

In 1993, terrorists tried to blow up the World Trade Center (WTC) using a truck full of explosives. The attack failed to blow up the buildings, but killed eight victims. As the number of casualties was small, and there were no airlines to defend, no compensation scheme was devised for the victims' families.

From an equity standpoint, it is very difficult to explain why a 2001 WTC victim should receive millions in government compensation while a 1993 victim should receive none.[152] Attempts in the U.S. Senate to broaden the victim base

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149. Examples include significant support for those choosing to engage in religious study rather than work, grants to Holocaust Survivors, righteous Gentiles (those who helped to save Jews during the Holocaust), and Prisoners of Zion (those who suffered jail, deportation and injury for being Jewish abroad), a significant monthly children's allowance, income support grants to persons with low or no income, twelve-week state-paid maternity leave.

150. *See* http://abcnews.go.com/sections/us/DailyNews/terrorvictims020103.html. This average amount does not include additional uncapped tax benefits under the Victims of Terrorism Tax Relief Act of 2001. *See infra* notes 154-55 and accompanying text.

151. *See supra* note 106 and accompanying text.

152. *See, e.g.*, Lucette Lagnado, *Terrorism's Forgotten Victims: Survivors of Past Terror Attacks Say They Deserve Money, Too*, WALL ST. J., Mar. 11, 2002, at B1; Jim Morris, *Families of Pan Am Bomb Victims Feel Numb After Sept. 11 Attacks*, DALLAS MORNING NEWS, Dec. 23, 2001,

eligible for compensation were also very limited in nature, applying to victims of specific past terrorist events.[153]

The inequity can be even better demonstrated by the Victims of Terrorism Tax Relief Act of 2001.[154] That law provides substantial tax benefits[155] to the victims of three terrorist events: the 9/11 attacks, the Oklahoma City bombing, and the terrorist attacks involving anthrax which occurred shortly after September 11, 2001.

What is notable about this law is that, first, the Oklahoma City victims were not deemed worthy of tax concessions in the six years between the time of their tragedy and the larger tragedy of 9/11. Second, the inclusion of the anthrax victims is significant given the fact that the perpetrators of that crime have not been caught. Therefore, the question of whether these acts qualify as terrorism (or qualify as terrorism to a greater extent than the victims of "Unabomber" Theodore Kaczynski, for example, who were not included in the law) is quite uncertain. Clearly, the only reason that the anthrax victims were included was the timing of the anthrax attacks, which occurred shortly after the 9/11 attacks and thus raised the assumption (or speculation) that they were related. Third, the victims of the 1993 WTC bombing were not included in the new law and neither were many other victims of acts that were clearly terrorist, although smaller and less dramatic in nature.[156]

What is even more striking, in an analysis of equity, is that the victims of September 11 received not only the largest compensation ever paid by the U.S. government, but also the benefit of a charitable response that was "extraordinary

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at 4A.

153. *See* Raymond Hernandez, *Traces Of Terror: Changes to Sept. 11 Fund Would Extend Aid to Victims of Past Terror Bombings*, N.Y. TIMES, May 24, 2002, at A22.

154. Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, 115 Stat. 2427 (2002).

155. The law would, *inter alia*, exempt affected taxpayers from income taxes for the year of death and at least one prior year and provide a minimum benefit of $10,000 to each victim. The amount of benefit depends on the deceased taxable income and appears to be unlimited. It would also exclude from taxation certain death benefits; shield $8.5 million in assets from federal estate tax for 2001; make it clear that payments by charitable organizations will be treated as exempt payments; provide an exclusion for certain cancellations of indebtedness; exclude workers' compensation benefits, death benefits, and payments from government retirement plans for taxation; provide tax-free treatment of death benefits paid by an employer to an employee who died as a result of a terrorist attack; exclude from income disability benefits for all persons injured in a terrorist attack; reduce the taxation of disability trusts; and increase the exemption amount for disability trusts. Terrence Chorvat & Elizabeth Chorvat, *Income Tax as Implicit Insurance Against Losses from Terrorism*, 36 IND. L. REV. 425 (2003).

156. Certain tax benefits were provided to victims of the 1988 downing of Pan Am flight 103 and to certain military personnel and U.S. government employees harmed by specific attack of terrorism. For a complete (and rather short) list of tax concessions related to military or terror events, see JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE VICTIMS OF TERRORISM TAX RELIEF ACT OF 2001 (JCX-93-01), 2-4 (2001).

in breadth and nature,"[157] probably due to the magnitude of the 9/11 attacks. Hence, the government aid in an ad-hoc system is more likely to be given to those who might not be the most needy.

2. Acceptance of Value Judgments by the Victims.—As was widely publicized, Kenneth Feinberg, who is overseeing the 9/11 Victim Compensation Fund, has had to make every possible value-based decision when deciding how to divide the funds among the victims' families.[158] Many of Feinberg's decisions have proven controversial, and the Justice Department has received thousands of comments on the rules as proposed, and then promulgated, by Mr. Feinberg.[159]

A permanent system would hopefully have long-term and well-thought equality superior to that of an ad hoc system created under daily pressure from interested parties. Value-based judgments should be made after due deliberation. Furthermore, value judgments expressed in permanent rules may be more acceptable to the victims and to the general public than the decisions of a person with final and uncontestable[160] authority in order to split a given budget more equitably and fairly. It would be much easier to accept long-established rules legislated by Congress than what appears to be arbitrary decisions made by one person.

3. Efficiency.—The discussion of efficiency addresses two separate issues. First, I will argue that a permanent system would achieve better allocative efficiency. This is so because the level of compensation is more likely to be set at its optimal level in a permanent system than by an ad hoc system. Second, the cost of administration (which in this case is the main part of a productive efficiency analysis) will be considered. The efficiency of administering a permanent system will be examined against the administration of ad hoc compensation scheme. As such, I will argue that an efficient solution depends on the number of compensable events and victims eligible for compensation and make a specific proposal adaptable to the United States, should it chose to adopt a permanent compensation system.

a. Allocative efficiency.—As discussed previously, the 9/11 Victim Compensation Fund, by far the most generous terror compensation scheme in U.S. history, was created primarily to protect the airline industry from countless law suits, as claimants who choose to receive the compensation forgo any right

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157. *See* Robert A. Katz, *A Pig in a Python: How the Charitable Response to September 11 Overwhelmed the Law of Disaster Relief*, 36 IND. L. REV. 251 (2003).

158. *See, e.g.*, Eli Kintisch, *The Right Man for a Job No One Could Have Wanted*, THE FORWARD, Jan. 4, 2002, *available at* www.forward.com/issues/2002/02.01.04/news10.html; Milo Geyelin, *Criticism of Sept. 11 Victims' Fund Sparks Backlash*, WALL ST. J., Jan. 23, 2002, at B1. *See also* Shapo, *supra* note 17, at 241-42.

159. *See* U.S. DEPARTMENT OF JUSTICE, SEPTEMBER 11TH VICTIM COMPENSATION FUND OF 2001, *at* http://www.usdoj.gov/victimcompensation/civil_03.htm (last visited Sept. 14, 2002). The Interim Final Rule has received 2687 timely comments and 628 additional comments that were filed after the date set for such comments. The final rule received 2953 comments.

160. The decisions of the Special Master administering the Fund are not subject to appeal.

to sue the airlines and certain other parties.[161] In that respect, at least some of the money budgeted for the fund may be viewed as part of the subsidy that the government decided to give the airline industry following the traumatic events of September 11.[162]

Although it was possible not to compensate victims of past attacks while the 9/11 victims were compensated, I assume that it would be very difficult politically not to compensate the victims of a high-casualty terror attack should it unfortunately occur in the near future. I also believe that the amount set for the 9/11 victims is likely to serve as precedent, or at least as a starting point, for the unfortunate victims of future similar-size attacks, should they occur. However, that precedential amount has been set at a level significantly higher than the public, through its representatives, would have set it had it been done so without the influence of the desire to protect the airlines.

Put differently, the allocation of federal resources to the Victim Compensation Fund partially reflects the sum of (I) compassionate feelings towards the victims' families and (ii) amounts which are part of the airline bailout. The amount provided to help secure the assistance to the airlines is the excess by which the level of compensation exceeds the optimal level.

Setting a compensation standard by public and congressional opinion, created by just one event, could also lead to under-compensation, if the defining event is one that causes public opinion to act only half-heartedly to provide the compensation.

Finally, if the level of compensation that differs from one terrorist attack to another is based on external factors such as the involvement of the airlines or a change in the economic climate, the inefficient result will also demonstrate the inequality between victims of different attacks.

b. Cost of administration.—As mentioned previously, Israel administers victims benefits through its NII, the equivalent of the Social Security Administration in the United States. The NII, which administers many of the social welfare plans in the non-federal Israeli state, has a permanent department administering the claims and the benefits.

By contrast, the United States had to create a special office within the Department of Justice to administer the Victim Compensation Fund. The same government unit, headed by Kenneth Feinberg, makes the rules and administers the claims. Since the U.S. system is based on a one-time payment to the victims' families, the office administering the fund is expected to wind down within a few years. Should the need arise, a similar office will have to be created anew in the future.

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161. *See supra* note 106 and accompanying text.

162. The Air Transportation Safety and System Stabilization Act, in § 101(a)(2) and § 101(a)(1) respectively, also provided the airlines with $5 billion to compensate them for losses resulting from the federal order to stop all air traffic following 9/11 and authorized up to $10 billion in federal loans or loan guarantees to the airlines. Pub. L. No. 107-42, 115 Stat. 230 (2001). For an analysis of the assistance to the airlines, see Margaret M. Blair, *The Economics of Post-September 11 Financial Aid to Airlines*, 36 IND. L. REV 367 (2003).

Whether it may be more efficient to have a permanent set of rules consistently applied and administered by a professional, permanent agency rather than having to create an ad hoc administration every time the need may arise depends heavily on the scope and frequency of compensable terrorist attacks. It is quite possible that the extended time between major terrorist events in the United States does not justify, at this time, the creation of a permanent agency. The Unites States may, however, have an existing agency which could potentially administer the benefits with very little additional cost. My proposal is to consider the administration of a permanent program by the Veterans' Administration.

As noted above, the Israeli system is based on a rationale which equates the benefits of civilian victims to those of military personnel injured or killed in action. If a similar rationale was to be adopted in the United States, for the reasons explained above,[163] it could provide an efficient means to administer the benefits at relatively low cost through the existing Veterans Administration.

4. Psychological Effect.—Terror is a tool of intimidation and is generally intended to have a damaging effect far greater than the actual physical damage caused.[164] In a country hit hard by terrorism, the knowledge that there is a fairly comprehensive safety net provided to victims is somewhat comforting.

By contrast, a country where there is no compensation system adds a significant specific economic fear to the general fear caused by terrorism. That economic uncertainty is significantly increased at a time when insurance companies hurry to exclude terrorist acts from their coverage or charge a significant premium to cover that risk.

C. Disadvantages of a Permanent System

1. Cost of Operation.—Permanent systems generally require a bureaucracy, which may be costly. This consideration has been discussed under *Efficiency* in the discussion of advantages of a permanent system.[165] As previously noted, the issue is really one of fact, depending mainly on the number of harmful terrorist attacks and how far apart those attacks are.

2. Untouchable Rights.—One drawback of a permanent system is that it appears to be causing the gradual increase in benefits over time. Once a permanent system is in place, it is very hard, politically, to reduce the benefits provided. If the Israeli experience is any precedent, the very existence of a permanent scheme creates frequent and successful demands to increase those included under the scheme and their respective benefits.

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163. *See supra* Part I.B.

164. *See, e.g.*, ROBERT H. KUPPERMAN & DARRELL M. TRENT, TERRORISM: THREAT, REALITY, RESPONSE 279-83 (1979).

165. *See supra* Part III.B.3.

CONCLUSION

At the end of the day, the main issue that remains was raised by the Israeli Finance Minister when introducing the first Compensation Law in 1951:[166] Who should bear the brunt of terrorism, the individuals who happened to be in the wrong place at the wrong time, or the general taxpaying public? The Israeli answer to that question is unequivocal, if not entirely efficient.

The U.S. answer to the same question has yet to be determined. Although the September 11 Victim Compensation Fund provided generous support to many of the victims' families, the general U.S. position regarding the right of victims to government compensation has remained open, perhaps with the hope that it will remain an academic topic.

166. *See supra* notes 14-15 and accompanying text.

THE ECONOMICS OF POST-SEPTEMBER 11 FINANCIAL AID TO AIRLINES

MARGARET M. BLAIR*

INTRODUCTION

In one of the first legislative responses to the terrorist attacks of September 11, 2001, Congress passed the Air Transportation Safety and System Stabilization Act[1] (ATSSSA), and President Bush signed it into law on September 23, 2001.[2] The ATSSSA provided $5 billion in immediate and direct payments to airlines to compensate them for losses resulting from the federal ground stop order during the first four days after the attack, and for further losses that the airlines were expected to incur as a result of reduced air traffic from September 23 through December 31, 2001.[3] The ATSSSA also created the Air Transportation Stabilization Board (ATSB)[4] and authorized it to issue federal credit instruments, such as direct loans or loan guarantees, totaling up to $10 billion,[5] to assist air carriers whose financial survival was put at risk by the terrorist attacks and the subsequent collapse in air traffic.[6]

The ATSSSA also caps the aggregate liability of each airline arising from the September 11 incidents or other terrorist acts at $100 million[7] and expands the existing authority for the government to provide war-risk liability insurance for aircraft operating on certain foreign routes[8] to cover domestic routes as well.[9] The new authority authorizes the Department of Transportation to subsidize insurance costs for at least 180 days after passage of the ATSSSA.[10]

As of early November 2002, the ATSB had closed on a loan guarantee of

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1. Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, 115 Stat. 230 (2001) [hereinafter ATSSSA].

2. James D. Tussing & Stewart B. Herman, *Government Acts to Bail Out U.S. Airlines*, 226 N.Y. L.J. 1 (2001).

3. ATSSSA § 101.

4. *Id.* § 102(b).

5. *See* U.S. Dep't of the Treasury, Office of Domestic Finance, Air Transportation Stabilization Board, *Mission*, *at* http://www.ustreas.gov/offices/domestic-finance/atsb ("The Board may issue up to $10 billion in Federal credit instruments, e.g. (loan guarantees).") (last visited Nov. 11, 2002).

6. ATSSSA § 102(c).

7. *Id.* § 201(b)(1)(B)(2).

8. 49 U.S.C. §§ 44301-44310 (2001).

9. ATSSSA § 201(a); Tussing & Herman, *supra* note 2, at 4.

10. ATSSSA § 201(b)(1)(B)(4).

$390 million for America West Airline (backing a loan of $429 million)[11] and had conditionally approved a loan guarantee of $900 million for US Airways.[12] Despite the offer of restructuring assistance from the ATSB, however, US Airways was unable to secure sufficient concessions from creditors, suppliers and labor quickly enough to prevent it from having to seek protection from the bankruptcy courts, which it did on August 11, 2002.[13] The ATSB did not rescind its loan guarantee, but on August 12, 2002, issued a letter confirming that the offer was still open, "subject to the conditions set forth in the Board's July 10 letter to US Airways and to the bankruptcy court's confirmation of a plan of reorganization."[14] As of early December 2002, US Airways was still in bankruptcy negotiations.[15] United Airlines' request for a $1.8 billion loan guarantee was rejected on December 4, 2002,[16] and on December 9, UAL Corp., the parent company of United Airlines, also sought protection from the bankruptcy court while it continued to negotiate with creditors and unions to restructure.[17]

Meanwhile, the ATSB had denied Vanguard Airlines its requested loan guarantee on July 29, 2002,[18] and had denied National Airlines, Inc. and Spirit

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11. *See* U.S. Dep't of the Treasury, Office of Domestic Finance, Air Transportation Stabilization Board, *Recent Activity, at* http://www.ustreas.gov/offices/domestic-finance/atsb/recent-activity.html [hereinafter ATSB, *Recent Activity*] (chronology of significant events) (last visited Nov. 11, 2002). The loan guarantee for America West was subject to stringent restructuring provisions, including a grant of America West stock options sufficient to give the government up to a one-third interest in the company if exercised. *See infra* notes 102-07 and accompanying text.

12. Frank Reeves & Jim McKay, *US Airways Loan Plan Given Key Approval*, PITT. POST-GAZETTE, July 11, 2002, at A1. The loan guarantee for US Airways was subject to the airline receiving further concessions from its employees and lenders, and offering a larger equity stake to the government. *See id.*; *see also* Keith L. Alexander, *Airlines Wait for Word from Board*, WASH. POST, July 27, 2002, at E1; Caroline Daniel, *Companies & Finance International—US Airways Given Extra Loan Conditions*, FIN. TIMES, July 12, 2002.

13. *See* Susan Carey, *US Airways, Hit Hard by Terror, Files Chapter 11; United May Be Next as Bid for Emergency Aid Snags; Carriers Wrestle With Costs*, WALL ST. J., Aug. 12, 2002, at A1.

14. *Air Transportation Stabilization Board's Statement on US Airways' Plan for Chapter 11 Reorganization*, Air Transportation Stabilization Board press release, Aug. 12, 2002, *available at* http://www.ustreas.gov/press/releases/po3342.htm.

15. *US Airways Posts $335 Million Loss*, WASH. POST, Nov. 2, 2002, at E3.

16. Susan Carey & Scott McCartney, *Charting United's Turbulent Future: Near Bankruptcy, Airline Boasts Coveted Routes That Could Save It; Labor Pacts Face an Overhaul*, WALL ST. J., Dec. 6, 2002, at A1.

17. Susan Carey & Thomas M. Burton, *UAL Files for Bankruptcy Protection*, WALL ST. J., Dec. 10, 2002, at A3.

18. *See* ATSB, *Recent Activity*, *supra* note 11. Vanguard Airlines had actually been denied a loan guarantee three times by the end of May, and had reapplied a fourth time on June 27, 2002. *See* Eric Palmer, *Vanguard Airlines' Future Up in Air*, MYRTLE BEACH SUN-NEWS, June 29, 2002, at D2.

Airlines, Inc., federal loan guarantees on Aug. 14, 2002.[19] On the other hand, it conditionally approved an application by American Trans Air, Inc. for a loan guarantee on September 26, 2002,[20] and conditionally approved guarantees for Frontier Airlines and Aloha Airlines in early November.[21] The remaining applications (by Corporate Airlines, Evergreen International Airline, Gemini Air Cargo, Great Plains Airlines, MEDjet International, and World Airways) were apparently still pending.[22]

Throughout this year, the Department of Transportation has also continued to subsidize airline insurance, according to authorization in ATSSSA.[23] The original legislation provided only that insurance be subsidized for the first 180 days after September 11, 2001, but DOT extended the authority in March, May, and June[24] and sought to extend it again in October.[25]

The idea of the federal government occasionally providing loan guarantees or other financial assistance to individual companies at risk of failure is not new. In fact, the list of federally financed or orchestrated "bailouts" of private corporations during the last few decades—including Lockheed (in 1971), Conrail (in 1976), Chrysler (in 1979), Continental-Illinois Bank (in 1984),[26] the restructuring of the Savings & Loan industry in the 1980s,[27] Long-Term Capital

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19. ATSB, *Recent Activity*, *supra* note 11. National Airlines ceased operations in early November, after two years in bankruptcy court. *See National Airlines*, WASH. POST, Nov. 7, 2002, at E2.

20. ATSB, *Recent Activity*, *supra* note 11.

21. *Frontier Airlines, Aloha Receive Approval for Loan Guarantee*, WALL ST. J., Nov. 6, 2002, at A2.

22. *See List of Airlines Seeking Aid*, ASSOCIATED PRESS, June 29, 2002; *see also* David Bailey, *ATA Files for Loan Guarantees from U.S.*, WALL ST. J., July 1, 2002, at B8; *Three Small Airlines Apply for Guarantees on Federal Deadline*, WALL ST. J., July 9, 2002.

23. *See supra* note 9 and accompanying text.

24. *See Airlines' War Insurance Is Extended by 60 Days*, WALL ST. J., Mar. 14, 2002; Stephen Power & Christopher Oster, *U.S. Extends Insurance Coverage Again for Airlines After Sept. 11*, WALL ST. J., May 16, 2002, at D6; *U.S. Government Extends War Risk Insurance*, COMMUTER/REGIONAL AIRLINE NEWS, June 24, 2002.

25. *See FAA APO Third Party War Risk Liability Insurance*, *at* http://insurance.faa.gov. (noting that "The FAA will offer an Amendment to the current Third Party War Risk Liability Insurance Policy which terminates on Wednesday, October 16, 2002. This Amendment will extend the coverage from October 16, 2002, to December 15, 2002.").

26. Robert B. Reich, *Bailout: A Comparative Study in Law and Industrial Structure*, 2 YALE J. ON REG., 163, 164 (1985) (listing all of the "bailouts" noted except the restructuring of the savings and loan industry, Long Term Capital Management, and Amtrak, but discussing only the Chrysler bailout at length, comparing the policy implications of government orchestrated bailouts of similar industrial companies in United States, Great Britain, Germany and Japan).

27. *See* Alane Moysich, *The Savings and Loan Crisis and Its Relationship to Banking*, *in* 1 FDIC, HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE 167 (1997), *available at* www.fdic.gov/bank/historical/history/167_188.pdf (describing the federal restructuring of the savings and loan industry in the 1980s).

Management (in 1998),[28] and the ongoing subsidy of Amtrak[29]—suggests that, if a company is large enough, and the impact of its failure potentially catastrophic enough, the federal government can be expected to get involved somehow in the financial restructuring of the company.[30]

Yet while the idea of occasional federal bailouts of large and economically important corporations which find themselves in serious financial distress is not new, it is unusual for legislation to be passed in anticipation of financial distress in an entire industry, offering the possibility of federal financial support to any and all comers from the industry.[31]

This Article considers the economic and policy merits of this unusual piece of legislation, the rules issued to implement the legislation, the industry response, and the implications of the actions taken so far by the ATSB under the ATSSSA.

I. ECONOMIC RATIONALES FOR SUBSIDIES AND BAILOUTS

Under what circumstances should government provide subsidies or other aid to support a particular kind of economic or other activity? As a general rule, economic theory tells us that private sector businesses will allocate resources efficiently in response to prices determined in free markets. This theory suggests

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28. *See* Tom Herman, *The Long-Term Capital Bailout: Historians Marvel at Rescue's Size, Twists*, WALL ST. J., Sept. 25, 1998, at A8 (describing the bailout); *see also* Matt Murray, *Fed Tells Banks to Tighten Standards for Loans They Extend to Hedge Funds*, WALL ST. J., Feb. 2, 1999, at A4.

29. *See* Don Phillips, *Agreement Reached on Aid to Amtrak*, WASH. POST, June 29, 2002, at E1.

30. Whether each of the named instances of federally-coordinated bailout was good policy or not, or whether it is generally good policy occasionally—but not predictably—to rescue a company from bankruptcy proceedings, are obvious questions for debate. This Article will not address these general questions, though it will offer some comparisons between the rationale for, and process by which previous bailouts worked, and rationale and processes envisioned in the airline bailout legislation.

31. To be sure, agricultural support legislation has been a regular staple of congressional action since the Depression. Some scholars have wondered why the federal government has been so willing for so long to grant huge subsidies to this industry. *See, e.g.*, David S. Bullock & Jay S. Coggins, *Do Farmers Receive Huge Government Transfers in Return for Small Lobbying Efforts?*, Mar. 2, 2001 (manuscript on file with author). I have not tried to figure out whether there is an economic difference between agricultural subsidies, and subsidies and bailouts of industrial companies, but clearly there is a political difference. One could also argue that the Federal Savings and Loan Insurance Corporation (FSLIC) was a vehicle put in place to make federal involvement in restructuring an entire industry inevitable, but it was not contemplated when the FSLIC was created that virtually all of the savings and loans in the industry would have to be bailed out at the same time. The Regional Rail Reorganization Act of 1982, 45 U.S.C. §§ 701-797 (1982), by which the federal government reorganized and combined several failing northeastern and midwestern railroads, may be the clearest precedent for the ATSSSA, although railroad reorganization was not precipitated by a war or other catastrophic event.

that government should not impose taxes or provide subsidies that distort the signal provided by these market prices. Nonetheless, it is widely appreciated that in the presence of certain "market failures," government regulation or subsidies may be necessary for markets to reach an efficient outcome.[32]

One type of market failure that might call for government intervention in the form of taxes or subsidies occurs when an activity generates "externalities."[33] For example, smoking is believed to cause harm to parties who do not themselves smoke—from second-hand smoke, for example, and also from the costs to society of additional burdens on the health care system. These are negative externalities whose costs are not automatically internalized in the price of cigarettes. Hence it is widely accepted that cigarette smoking should be taxed rather heavily to raise the price of smoking to smokers and thereby encourage them to kick the habit.

Similarly, scientific research often produces positive "externalities"—benefits that vastly exceed those that can be captured (through salaries, patent rights, etc.) by the researchers. So federal and state governments provide substantial ongoing subsidies to support scientific research.[34]

"Public goods" are special cases of goods with positive externalities.[35] A public good is a commodity that benefits everyone within a given country or community regardless of whether they have paid for the good.[36] Moreover, it costs no more to provide the good for everyone than it does to provide it for one person.[37] A common example of a public good, and one that may be of particular relevance to this discussion, is national defense. Economists generally agree that efficiency can be enhanced by taxing citizens to provide government subsidies for public goods and for other goods or activities that have positive externalities.

Another situation in which government subsidy or regulation might sometimes be needed to achieve economic efficiency is a natural monopoly, in

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32. *See, e.g.*, JOHN B. TAYLOR, PRINCIPLES OF MICROECONOMICS 453 (Denise Clinton ed., 1995) (defining market failure as "any situation in which the market does not lead to an efficient economic outcome and in which there is a potential role for government").

33. *Id.* at 516 (defining an externality as a situation in which "the costs of producing a good or the benefits from consuming a good spill over to individuals who are not producing or consuming the good.").

34. Author's calculations from National Science Board data indicate that, in 2000, federal, state and local government funding for research and development totaled more than $67 billion, or about 27% of total R&D expenditures by government, industry, universities and colleges, and other nonprofit institutions. *See National Science Board*, Appendix, Table 4-4, *at* http://www.nsf.gov/sbe/srs/seind02/pdf_v2.htm#c4.

35. TAYLOR, *supra* note 32, at 511 (defining "public good" as "a good or service having two characteristics, *nonrivalry in consumption* and *nonexcludability*;" "nonrivalry" is further defined as a situation in which increased consumption by one person does not reduce the availability of the good for consumption by another; "nonexcludability" is defined as a situation in which it is impossible to prevent people from consuming a good).

36. This is due to the "nonexcludability" characteristic of the good.

37. This is due to the "nonrivalry" characteristic.

which there are very high fixed costs to provide some good or service, so that the average cost of providing the good always exceeds the marginal cost.[38] In such a situation, private sector providers of the good would have to charge at least the average cost for each unit of their products to avoid financial ruin, but would be under pressure in a competitive market to charge only the marginal cost. In such industries, price wars tend to squeeze smaller players out, and the industry tends toward monopoly, with all of its pathologies.[39] Government might be able to help solve this problem by providing or subsidizing the construction of the fixed assets that are the source of declining average cost structure.

A fourth reason that government regulation or subsidy might be justified is simply that society may have goals other than efficiency that will not be met in a pure free market economy. For example, U.S. society places a very high value on education, which is expressed by providing free public education through high school for all U.S. residents under the age of eighteen, and by heavily subsidizing post-secondary education.[40]

Thus, in analyzing Congress's decision to offer financial support to airlines in the wake of the September 11 terrorist attacks we should ask whether the attacks created a market failure in the air transportation system that was not there before or exacerbated an existing one. In particular, we will ask whether some new or enhanced market failure threatened the continued operation and financial health of individual airlines, or of the airline industry as a whole, or whether the industry provides some kind of public good or produces some other positive externality that justifies subsidy, or whether financial health of the airlines serves some other social goal whose value exceeds the cost of the financial support given.

There are several possible reasons why subsidies to the airline industry in the wake of the September 11 terrorist attacks might be economically efficient.

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38. TAYLOR, *supra* note 32, at 314 (defining natural monopoly as an industry in which average total cost is declining over the entire range of demand and the minimum efficient scale is larger than the size of the market).

39. In an industry that is a natural monopoly it is generally more operationally efficient for the market to be served by a single provider. But if that single provider is not regulated, it will tend to "over charge" customers by charging the revenue maximizing price. For a monopolist, this price is higher than the price at which the marginal cost of supplying the next unit is equal to the marginal value of the next unit to customers. *Id.* at 547.

40. Economic analysis generally indicates that the private benefits of education exceed the costs, and so one might think that people would have an incentive to get an education even without public subsidies. But liquidity constraints may prevent a large proportion of the population from getting an education, despite the long-term expected benefits. Moreover, some scholars argue that having an educated population produces economic benefits to a society that exceeds the sum of the private benefits—in other words, education has positive externalities. *Id.* at 518. Both possibilities would provide purely economic rationales for public subsidies to education, in addition to the social value rationale.

A. The Air Transportation System as a Whole is a Natural Monopoly

The reason is that there are huge fixed costs associated with constructing and maintaining airports, in providing an air traffic control system, and, of special relevance since September 11, in providing security.[41] Hence the government (at federal, state and local levels) has long been heavily involved in financing the air transportation system by providing (and subsidizing) airports, the air traffic control system, and now airport security. Given that these facilities and systems were in place prior to September 11 and are not easily redeployed, efficiency is generally enhanced the more the facilities are used.[42] If usage falls off suddenly, as it did in the aftermath of the September 11 attacks, the overall efficiency of the air transportation system might be enhanced by some sort of stimulant to additional travel.

This argument might provide a rationale for the government to stimulate travel by subsidizing travelers (for example, by providing tax deductions for personal travel as well as business travel, suspending federal aviation taxes,[43] or buying and distributing the equivalent of frequent flyer miles to taxpayers (e.g., like the $300 advances on 2001 tax cuts distributed to many taxpayers during the summer of 2001). While subsidizing travelers might be expected to boost travel in ordinary times, in the first few months after September 11, travel was probably more likely to be increased by increasing travelers' confidence that air travel would be safe and convenient. As discussed below, the quick passage of the ATSSSA by Congress may have had significant value as a reassurance to travelers.[44] In any case, the natural monopoly argument only translates into an argument for directly subsidizing individual airlines if the subsidies to airlines

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41. One could also argue that there are substantial fixed costs involved in providing hotel, restaurant, and rental car services to people who use the air transportation system. But these costs, while large in the aggregate, may be less "fixed" in the sense that they are more easily broken up into small units that can be provided incrementally (or redeployed to other uses) in response to changes in demand. Nonetheless, one might reasonably ask why, if it is regarded as a federal responsibility to subsidize the losses incurred by airlines in the wake of September 11, it should not also be a federal responsibility to subsidize the entire travel sector. I will not attempt to address this question in this Article.

42. This is because the marginal cost of adding one more passenger or one more flight is very small when the system is not operating at full capacity. At some point, however, increased usage of the air transportation system by travelers would begin to have a negative externality cost in increased congestion, but those costs can usually be internalized through some type of "peak-load" pricing by the airlines in selling seats on their various flights. The analysis above assumes that, in the aftermath of September 11, the system as a whole has operated well below maximum capacity for an extended period of time, so that the cost at the margin of an additional traveler flying an additional flight is well below the average cost of providing that seat to that flyer.

43. Federal aviation taxes include both a ticket tax and a fuel tax. This solution is recommended in Steven A. Morrison & Clifford Winston, *Bailing Out the Airlines*, BOSTON GLOBE, Sept. 24, 2001, at 19.

44. *See* Conclusion, *infra*.

are passed through to travelers in the form of reduced ticket costs.

B. Each Link in the Air Transportation System Produces Positive Externalities

The idea here is that each functioning link in the transportation system has a value as part of the network that exceeds the value of that link in isolation. The idea of such network externalities has been applied to such things as telephone service and computer software: having access to telephone service increases in value when more people have telephone service; likewise, some software programs become more valuable with more users.[45] Yet the idea of network externalities in air transportation is less obvious.

Suppose that Point One is a "hub" in an air transportation system (a major airport through which passengers are routed and regrouped to be carried to their destinations on connecting flights). Airline A provides service on a route between Point One and Point Two, which not only benefits travelers who want to travel from One to Two, or from Two to One, but may also benefit travelers who want to go from Two to Three, or from Two to Four, if they can get to those other destinations from Two by going through Point One. Thus, each route serving an additional destination from Point One increases in value due to the existence of the other destinations already served from that hub. If Airline A provides service to and from two dozen cities (Two through Twenty-five) from the airport at Point One, then if Airline B provides service between some other city (Twenty-six) and Point One, the value of that single link is enhanced by the existence of the links that Airline A offers from the airport at Point One to places Two through Twenty-five.

The existence of network externalities achieved through a "hub-and-spoke" system design suggests that Airline B benefits from the fact that Airline A provides service from Point One to cities Two through Twenty-five. In other words, A's hub system generates positive externalities for Airline B. The link provided by B to destination Twenty-six also adds some value to Airline A's hub.[46] To the extent that there are network externalities in hub-and-spoke systems, a decline in service into and out of a hub by one airline may have spillover costs to other airlines that serve that hub. On the other hand, if Airline A cuts back its service out of Point One, this might create an opportunity for airline B to profitably expand its service out of that hub,[47] so it is not clear

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45. *See* Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 AM. ECON. REV. 424, 424 (1985) (defining the concept); Michael L. Katz & Carl Shapiro, *Systems Competition and Network Effects*, 8 J. ECON. PERSP., 93, 93-115 (1994) (discussing network effects in communications systems and in software systems).

46. "Everyone benefits by consolidated routes and more cross-country and transcontinental travel. And having these large national airlines aids that network effect," Yale law professor George L. Priest told the *New York Times* in the fall of 2001. Stephen Labaton, *Airlines and Antitrust: A New World. Or Not*, N.Y. TIMES, Nov. 18 , 2001, at C1.

47. As will be discussed below, there is evidence that small regional carriers have been taking

whether the net effect on B is positive or negative. Hence it is unclear whether the general collapse in demand for air travel after September 11, combined with the existence of network externalities associated with airlines that operate with hub-and-spoke configurations, implies any role for government action.

The analysis is complicated, however, by the fact that hub-and-spoke systems have some of the characteristics of a natural monopoly. The establishment of a hub involves substantial fixed costs, and the marginal cost to a hub-and-spoke operator of operating an additional route that connects that hub to another destination point will generally be lower than the average cost of operating all the routes into and out of that hub.[48]

The unusual economics of hub-and-spoke operations may help explain several recurring patterns in the airline industry since the industry was deregulated in 1978. First, the major airlines that operate hub-and-spoke systems have had trouble maintaining profitability, especially during recessions or widespread economic slowdowns[49] Meanwhile, some regional carriers that do not operate hub-and-spoke systems have managed to be profitable even in down cycles (Southwest Airlines has established the most successful of the low-fare non hub-and-spoke business models, but other regional airlines such as JetBlue and Frontier have lately begun pursuing the same model[50]). Finally, hub-and-

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advantage of cutbacks by major carriers in the current market to attract business travelers, who have traditionally tended to give their business to the major airlines that operate hub-and-spoke operations. *See infra* notes 120-26, 150-53 and surrounding text.

48. Economists and airline analysts have argued that hub-and-spoke operations produce "economies of scale" that save the operator costs by "centralizing maintenance and allowing the use of larger planes that are filled closer to capacity because people can be gathered from many places, sorted out at the hub with timely connecting flights, and sent on to many other places." Steven A. Morrison & Clifford Winston, *The Remaining Role for Government Policy in the Deregulated Airline Industry*, *in* DEREGULATION OF NETWORK INDUSTRIES: WHAT'S NEXT?, 4 (Sam Peltzman & Clifford Winston eds., 2000). But because the upfront costs of establishing a hub can be high, hub operations have generally been assumed to create barriers to entry to other airlines, which some economists believe make it possible for hub-and-spoke operators to charge a "hub premium,"—a ticket price for trips routed through the hub that is higher than it otherwise would be because of lack of adequate competition by non hub-and-spoke operators serving that same origin and destination point. But lately, economists have begun to question the "hub premium" argument, as well as the notion that hub-and-spoke operations have lower operating costs, noting that Southwest Airlines has managed to successfully underprice many hub-and-spoke operators because its costs per mile are consistently lower than the larger hub-and-spoke airlines' costs. *See id.* at 5-6.; *see also* discussion, *infra* Part VII.

49. Steven A. Morrison & Clifford Winston, *Causes and Consequences of Airline Fare Wars*, *in* BROOKINGS PAPERS ON MICROECONOMIC ACTIVITY 85, 85 (1996) (noting that "[s]ince the airline industry was deregulated, its financial performance has continued to be extremely volatile."). They estimate, for example, that from 1990 to 1993, a period which included a mild recession *and* the Gulf War, the industry lost nearly $13 billion. *Id. See also* Rodney Ward, *September 11 and the Restructuring of the Airline Industry*, DOLLARS & SENSE, May 1, 2002, at 16.

50. *See, e.g.*, Melanie Trottman & Scott McCartney, *Executive Flight: The Age of "Wal-*

spoke operators are frequently accused of predatory behavior such as initiating fare wars in hopes that they can outlast and drive out of business the regional carrier competing with them on routes that would otherwise be quite profitable for the hub operator.[51] While these fare wars are good for travelers, they leave the airline industry as a whole continually struggling for profitability.[52]

One of the implications of this analysis is that, if all other factors are equal,[53] hub-and-spoke systems should be able to operate at a lower average cost than non-hub-and-spoke operators during periods of high demand, but they may be less able to cut costs during periods of slow demand. Meanwhile, to the extent that hub-and-spoke operations provide positive externalities to other airlines that operate individual routes into and out of that hub, there may be a valid economic reason for subsidizing hub-and-spoke operators at least enough to prevent them from failing during slow times and closing down their hub operations. However, this would only be true if the hub operators could be prevented from using the subsidy to sustain them through a fare war designed to drive a competing regional carrier out of some market.

Applying these arguments to the specific policy questions that arose in the

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Mart" Airlines Crunches the Biggest Carriers, WALL ST. J., June 18, 2002, at A1.

51. Morrison & Winston, *supra* note 48, at 7 (noting that "[c]ritics have been accusing [major] airlines of predatory practices for more than a decade."). In the spring of 1998, a Transportation Department report found that

> [i]n recent years, when small, new-entrant carriers have instituted new low-fare service in major carriers' local hub markets, the major carriers have increasingly responded with strategies of price reductions and capacity increases designed not to maximize their own profits but rather to deprive the new entrants of vital traffic and revenues.

Id. (citing U.S. Department of Transportation, Office of the Secretary, Docket No. OST-98-3713, Notice 98-16). Morrison and Winston find evidence that the entry into a market by a low cost carrier such as Southwest or ValuJet increased the probability of a fare war in that market, but they did not find evidence that the established carriers initiated the wars or acted in a predatory manner. Morrison & Winston, *supra* note 49, at 108-16. *See also* Morrison & Winston, *supra* note 48, at 8 (noting that large changes in fares or in capacity by large airlines in response to entry by nonmajors are unusual).

52. Morrison & Winston, *supra* note 49, at 120 (estimating that from 1979 through 1995, fare wars reduced airline industry profits by $7.8 billion). *See also* Samuel Buttrick et al., *Airlines: Industry Update; Estimates Reduced Further*, UBS WARBURG GLOBAL EQUITY RESEARCH, June 20, 2002, at 6 ("Trading airline stocks may be hazardous to your wealth. Over the long-term, a diversified portfolio of airline stocks has reliably underperformed broader market averages.").

53. Other costs are not equal, of course. The major airlines which typically operate hub-and-spoke systems are also more likely to have unionized workforces and older average workers, which raises their costs relative to small regional carriers. Southwest and other low-fare carriers, for example, tend to have younger fleets, which require less maintenance, and have younger labor forces that aren't tied to complicated, inefficient labor contracts. Labor costs at AirTran Airways, Frontier, and JetBlue represent only 25% of revenue, while at Southwest, they represent 30% of revenue, and at United and Delta, labor costs are 40% of revenue. *See* Trottman & McCartney, *supra* note 50, at A8.

weeks and months after September 11 suggests that any effort by the federal government to provide financial support to individual airlines will, almost inevitably, involve the government in the complex question of determining which (if any) airlines are generating positive externalities by their operations, and how those airlines can be subsidized without encouraging them to engage in predatory practices against actual and potential competitors.

C. Transportation Systems That Provide Many Links in General Provide Positive Externalities

Shippers, travelers, and potential shippers and travelers benefit from having a richer opportunity set of routes through which they can fly or ship goods. This is simply an extension of the network externalities argument. A case can probably be made that the more functioning links there are in an air transportation system, the more valuable the system as a whole is to society. This line of argument suggests that there are positive externalities to each link in a smoothly functioning air transportation system that provides links to many locations, and that if government action is required to maintain each link, it might be efficient to take such actions.

The ATSSSA responds directly to this possible market failure by assigning to the Secretary of Transportation the responsibility to "take appropriate action to ensure that all communities that had scheduled air service before September 11, 2001, continue to receive adequate air transportation service and that essential air service to small communities continues without interruption."[54]

Although some airlines might have to be subsidized to keep the whole system functioning,[55] it does not follow from this analysis that any specific airline should be subsidized.

D. Relatedly, Having a Well-functioning Transportation System That Can Move People and Goods Smoothly and Quickly to Wherever They Are Valued More Provides a Type of Public Good

In what sense are transportation systems "public goods?" While most of the trips that individual travelers take when they use that system are private goods for which they pay at least the marginal cost,[56] note that if a well-functioning and

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54. Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, § 105(a), 115 Stat. 230 (2001). There are, of course, compelling political reasons for Congress to attempt to ensure continued air service to all communities, but the purpose of this section of the Article is to examine the economic reasons that might justify the provisions of the Act.

55. The ATSSSA also authorizes the Secretary of Transportation "to require an air carrier receiving direct financial assistance under this Act to maintain scheduled air service to any point served by that carrier before September 11, 2001." *Id.* §105(c)(1). Thus, the ATSSSA makes it possible to use subsidies of specific airlines as a mechanism to ensure that all the links in the system are maintained.

56. Air fares are notoriously variable, even for seats on the same row of the same flight. *See* Keith L. Alexander, *The Price Is Different: Complaints Are Up as Passengers Learn There Can*

complete air transportation system is in place, everyone has the *option* to travel, even if only a few people take advantage of that possibility on any given day.[57] The value of that option is a public good in the sense that having the system in place gives the option to everyone at the cost of providing it to the subset of people who actually use it on any given day, and one traveler's decision to use the system does not, for all practical purposes, diminish the option value for other potential travelers.[58] "People want assurances that the airlines will keep flying, just as they want water companies to keep providing their resources," noted

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Be Dozens of Fares for a Flight, WASH. POST, Apr. 6, 2002, at E1. The variation results from tactics airlines use to price discriminate, which allows them to charge higher prices to travelers with a high marginal benefit of flying. This tactic fills some of the seats with people who pay the average cost or even more, while charging the lowest prices to travelers with the lowest marginal benefit of traveling. The airlines use this tactic in hopes of filling the last few seats on the plane (which have a very low marginal cost to the airline).

57. Airlines have long tried to take advantage of the fact that the travel option is valuable, and especially that it is more valuable to some travelers (generally business travelers) than to others, by charging higher fares for tickets that come with fewer restrictions and/or are refundable.

58. Professor Ed Kitch suggested to me that this argument might be extended to a wide variety of goods and services, raising the question of whether there is something special about transportation systems in this regard. Although I have not seen this argument made elsewhere and have not worked through all of its implications, it seems to me that transportation is different. Unlike food, or apparel, or housing options, for example, transportation options have the effect of expanding the set of transaction options of all other types that are available to individual actors in an economy. Communication systems have a similar effect as do public marketplaces (including financial markets and virtual marketplaces). Thus, transportation systems have an especially enriching impact on economic activity. Transportation "is crucial to the rest of the economy, like electric power," observes Alfred E. Kahn, a professor of political economy at Cornell who oversaw deregulation as president of the Civil Aeronautics Board. Edward Wong, *The Impossible Demands on America's Airlines*, N.Y. TIMES, June 16, 2002, at 4. This may explain why, throughout history and across countries, governments often heavily subsidize the internal transportation systems of their countries. *See, e.g.*, Sylvia de Leon, *No Way to Run a Railroad*, WASH. POST, June 24, 2002, at A19 ("Not a passenger rail system in the world runs without some form of government investment. Nor is there any system of domestic transportation that does not rely on direct or indirect subsidy."). Government subsidization includes roads, canals, and railroads, as well as airlines.

> Governments built public roads, highways and expressways. Private companies built railroads and streetcar lines, but on rights-of-way owned by governments or confiscated by them for the public good, and frequently with generous helpings of public money for construction. The federal government nurtured private airline companies with air-mail fees and still owns and operates the air traffic-control system. Local governments build most airports.

Thomas G. Donlan, *Plane Arriving on Track 3: The Airline Industry May Replicate the Sorry Fate of the Railroads*, BARRONS, July 1, 2002; *see also* Don Phillips, *Agreement Reached on Aid to Amtrak*, WASH. POST, June 29, 2002, at E1. A full development of this idea will have to await future work.

Edward Wong recently in the *New York Times*.[59]

E. The Existence of a Well-functioning and Complete Air Transportation System May also Serve a Non-economic Social Goal

For example, ease of travel may help to tie together a diverse and widely-scattered population into a unified nation. Both of the latter two possibilities provide an argument for subsidizing the air transportation system as a whole. Indeed, the regulations implementing the ATSSSA issued by the Office of Management and Budget assert that the purpose of the federal credit instruments authorized under the Act to assist financially struggling airlines is "to facilitate a safe, efficient, and viable commercial aviation system in the United States."[60]

But here again, while there are potentially legitimate arguments for federal involvement of some sort to ensure the continued existence of a smoothly functioning, safe, and efficient air transportation system, it is not obvious that subsidizing individual airlines, either by directly reimbursing their costs or by providing loan guarantees to them, is the best way to achieve this goal.

II. ECONOMIC PROBLEMS FACING AIR CARRIERS SINCE SEPTEMBER 11

By almost any measure, the airline industry suffered a huge economic cost in the wake of the events of September 11. First, all air travel was stopped entirely in the United States for four days, and then resumed very gradually. By the end of September 2001, domestic enplanements were down 34% from September 2000, and international enplanements were down about 23%.[61] In late September, airline analysts estimated that airlines would be forced to reduce their output in 2001 by about 20%, or $20 billion.[62] With the spillover effect that the drop in air travel would have on hotels, restaurants, and tourism in general, the net loss to the economy was expected to represent as much as a one percent decline in gross domestic product, representing a significant worsening of the recession which was already under way.[63] Six months later, domestic enplanements were still down significantly, off by 14% from the previous year's level,[64] and by the end of September 2002, were down 8.7% for the first three quarters of the year compared with the comparable period in 2001, a period weakened by recession and the events of September 11.[65]

Although airline analysts are predicting an eventual full recovery of airline

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59. Wong, *supra* note 58, at 4.

60. Regulations for Air Carrier Guarantee Loan Program Under Section 101(a)(1) of the Air Transportation Safety and System Stabilization Act, 14 C.F.R. pt. 1300 (2001).

61. Stephen Power, *FAA Expects Fares to Decline This Year but Forecasts a Sharp Increase for 2003*, WALL ST. J., Mar. 12, 2002, at A2.

62. Morrison & Winston, *supra* note 43, at 19.

63. *Id.*

64. Power, *supra* note 61, at A2.

65. Air Transport Association Monthly Passenger Traffic Report, *available at* http://www.airlines.org/public/industry.

traffic to pre-September 11 levels by 2004, the collapse in travel in 2001 and 2002 has been devastating to corporate profitability. The industry lost $7.5 billion in 2001 (even after accounting for the $5 billion in cash grants given airlines last fall under the ATSSSA),[66] and is expected to lose another $8 billion in 2002[67] and at least another $1 billion to $1.5 billion in 2003.[68]

Major financial losses in most industries are generally a signal that the industry has too much capacity in place relative to demand, and that some capacity must be shut down. Indeed, this is exactly the case in the airline industry for the years 2001 and 2002. Yet, unlike the situation of excess supply in the steel industry, for example, no one expects the decline in air traffic to be permanent, so the losses are not regarded as a signal that capacity should be permanently reduced. Nonetheless, some capacity had to be taken out of service for a while, and the losses associated with the furloughed capacity must be absorbed somehow.[69] One goal of the ATSSSA was to mitigate the transaction costs associated with temporary capacity reductions.[70]

The immediate financial impact on the airlines of the collapse in traffic was offset to some degree by cash payouts provided by the ATSSSA. By October 5, 2001, just twenty-four days after September 11, the government had already paid out over $2 billion to the ten largest airlines. These initial payments, plus the additional $3 billion in payments paid out over the next few months, prevented the cash flow crisis from turning into a rash of bankruptcies at a number of small airlines and even a few large airlines. But for airlines that were already weak, the cash grants only postponed the need for dramatic restructuring and refinancing.

III. COMPARISON TO EARLIER CORPORATE BAILOUTS

Although political pressure to bail out large corporations in the past has often come from labor organizations that wanted to save jobs, Robert Reich has argued that the role played by government bailouts of corporations in the past has not, ultimately, been to preserve jobs or to avoid needed restructuring.[71] In the bailouts that he studied, all of the corporations ultimately shrank substantially and redeployed many assets. The bailouts, in fact, accomplished many of the same things that might have been accomplished more quickly in a bankruptcy proceeding or private workout. Government involvement, he argued, does little

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66. John Schmeltzer, *Airlines in Push for Credit Lines; Immediate Loans Less Attractive*, CHI. TRIB., Mar. 29, 2002.

67. *US Airways Posts $335 Million Loss*, *supra* note 15.

68. Buttrick et. al., *supra* note 52, at 2.

69. Air Transport Association, *State of the U.S. Airline Industry: A Report on Recent Trends for U.S. Air Carriers* (2002), at 3 (noting that at the end of 2001, U.S. airlines had parked or retired some 350 aircraft).

70. Regulations for Air Carrier Guarantee Loan Program Under Section 101(a)(1) of the Air Transportation Safety and System Stabilization Act, 14 C.F.R. Pt. 1300 (2001).

71. Reich, *supra* note 26, at 222.

more than "slow the pace of shrinkage."[72]

Consider the Chrysler bailout, for example. Chrysler had been performing poorly throughout the 1970s, and in 1978, it lost $204.6 million on sales of somewhat less than $13 billion.[73] Debts were mounting, and in the second quarter of 1979, Chrysler lost $207 million on $3 billion in sales.[74] At the time, Chrysler employed 140,000 people, and hundreds of thousands more worked for suppliers. John Riccardo, then president of Chrysler, hoped that the new Democratic administration might be sympathetic to the idea of federal help to avoid massive layoffs.[75]

By August 1979, the Carter administration had decided to help Chrysler, but not through tax waivers or other direct subsidies as Riccardo had hoped. Instead, G. William Miller, the new Secretary of the Treasury, proposed to introduce legislation to provide up to $750 million in loan guarantees, but only if Chrysler came up with an acceptable restructuring plan that included financial concessions from lenders, wage concessions from employees, and other concessions from suppliers, dealers, and state governments. Moreover, Riccardo would have to step down as Chrysler president.[76] Chrysler lost $450 million in its third quarter—a record loss at the time for a single company in a single quarter. Congress held hearings at which John McGillicuddy of Manufacturers Hanover (Chrysler's lead bank) said that Chrysler executives had "substantially exhausted their remedies in the private sector."[77]

By early November, the Carter administration had decided that it would take at least $1.5 billion in loan guarantees to help Chrysler recover. Although there was no organized opposition to a bailout, a number of members of Congress pressed for certain provisions, including greater concessions by employees. The bill that was finally enacted on December 20 provided guidelines for $2 billion worth of concessions from banks, employees, dealers, and suppliers, and $1.5 billion worth of federal loan guarantees to be doled out in several pieces, as the other restructuring moves were accomplished. It also established a loan guarantee board, which consisted of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the Comptroller General.[78] Finally, the legislation gave the federal government 14.4 million warrants to buy Chrysler stock.[79]

With the federal legislation in place, Chrysler was able to get the necessary

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72. *Id.* at 224. *See also* Noam Scheiber, *The Airlines Sure Needed a Lift. Or Did They?*, WASH. POST, Jan. 13, 2002, at B2 ("[T]he average federal bailout has traditionally been a Chapter 11-style bankruptcy in all but name. And that goes for the loan guarantee portion of this most recent 'bailout' [the loan guarantee part of the ATSSSA] as well.").

73. Reich, *supra* note 26, at 181.

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.* at 183.

78. *Id.* at 183-84.

79. *Id.* at 185.

concessions, though with considerable difficulty. During the next year Chrysler got out of the full-sized car business and concentrated its production on compacts and subcompacts. It also closed a number of plants. Still the company's fortunes did not improve. At the end of 1980, Chrysler went back to the board for more money. In January 1981, in a last desperate attempt to make the bailout work, Miller called the relevant parties to a meeting and demanded even more concessions. With those in place, the board approved a final $400 million in loan guarantees.[80]

Chrysler's fortunes finally turned, and by 1983, the company made a profit of $700 million. Its long-term debt had been slashed, and total employment was down to about 70,000 people. Chrysler had not failed to pay any of the debts that had been guaranteed by the government, and in fact, the federal government was able to redeem its warrants for $311 million.[81]

Although many economists and free-market advocates remain unconvinced that saving Chrysler produced greater economic efficiencies than would have been achieved by letting Chrysler be restructured in bankruptcy, the fact that the company did ultimately recover, and that the government not only did not lose money, but actually made money on the deal, helped to make this bailout something of a model. The terms of the ATSSSA, discussed below, seem to require that loan guarantees to any airline pursuant to the ATSSSA follow the Chrysler model.

IV. STRUCTURE OF THE BOARD AND TERMS OF THE ACT

In many respects, the "bailouts" contemplated by the ATSSSA follow the model established by the Chrysler Corporation bailout. First, the ATSSSA created a special board, the Air Transportation Stabilization Board (ATSB), to review each application for federal credit guarantees, and to monitor the companies that are given any such support.[82] The make-up of this Board strongly resembles the board that oversaw the Chrysler rescue. In particular, the Board consists of the Secretary of Transportation (or his designee), the Chairman of the Board of Governors of the Federal Reserve System (or his designee), and the Comptroller General of the United States (or his designee), who serves as a non-voting member. The Federal Reserve Board Chairman serves as Chair of the Board.[83] The board established by the Chrysler Loan Guarantee Act consisted of the Secretary of Treasury, the Chairman of the Federal Reserve Board, and the Comptroller General.[84]

Second, the ATSSSA designates that the ATSB can issue federal credit instruments only to firms "for which credit is not reasonably available at the time

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80. *Id.* at 186.

81. *Id.* at 186-87.

82. Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, § 102(b)(1), 115 Stat. 230 (2001).

83. *Id.* § 102(b)(2).

84. *See* Reich, *supra* note 26, at 183-84.

of the transaction."[85] Likewise, Congress only became willing to seriously consider providing loan guarantees to Chrysler after Chrysler's lead banker came before them and pleaded that Chrysler had exhausted all other options in the private credit markets.

Third, any airline seeking federal support must be of such substantial importance to the overall air transportation system that provision of financial support is determined by the Board to be "necessary" to the maintenance of a "safe, efficient, and viable commercial aviation system in the United States."[86] Similarly, the rescue of Chrysler was believed to be critically important to the health of the U.S. economy and to the viability of U.S. automakers in international markets.

Fourth, to qualify for assistance under the ATSSSA, airlines must demonstrate that they have a viable business plan that, in practice, extracts substantial concessions from other stakeholders, just as Chrysler had to extract painful concessions from its bankers, its employees, and its suppliers. ATSSSA section 104(a) in particular requires that senior executives of any airline seeking a loan guarantee (including anyone whose total compensation exceeded $300,000 in 2000) not receive any increases in compensation before September 11, 2003.[87]

Finally, as was done in the Chrysler rescue plan, the Act requires that the federal government be "compensated for the risk assumed in making guarantees" to airlines or their creditors to "the extent feasible and practicable,"[88] and that the terms of the transaction ensure that the government will participate in any subsequent financial success of the rescued airline.[89] As will be discussed in the next section, this has so far meant that the government has demanded warrants or options to buy stock of the "bailed out" airline in exchange for loan guarantees.

The ATSSSA model differs from the Chrysler bailout model in two very important respects, however. First, is the fact that the ATSSSA also offered a total of $5 billion worth of no-strings-attached cash payments to be paid out to every airline that applied, in proportion to that airline's share of the "available seat miles" market. These payments were meant to prevent a widespread cash flow crisis from devastating the industry in the immediate aftermath of September 11, and they were justified as compensation to the airlines for the losses they suffered as a result of U.S. government orders to curtail flights. Second, the ATSSSA limits the liability of airlines for damages caused by any terrorist act or act of war and provides that the ATSB can subsidize the purchase of liability insurance to cover the period from October 1, 2001 through September 30, 2002, for any airline, to the extent that insurance costs rise in response to the events of September 11. Like the cash payments, the insurance subsidies are available to any airline with no strings attached. The fact that these

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85. ATSSSA § 102(c)(1)(A).
86. *Id.* § 102(c)(1)(C).
87. *Id.* § 104(a).
88. *Id.* § 102(d)(1).
89. *Id.* § 102(d)(2).

two forms of subsidy were provided proportionately to all airlines means that they have not had the effect of distorting competition in the airline market by favoring one airline over any other. Hence, they have generally not been as controversial as the loan guarantee part of the ATSSSA program.[90]

V. INITIAL INDUSTRY RESPONSE

The first airline to step forward and ask for federal loan guarantees after the Act was passed and the rules were promulgated explaining the application requirements was America West Airlines, the eighth largest U.S. airline. America West submitted its application on November 13, 2001.[91] America West had been struggling financially before September 11 because of the softening of the economy and decline in business travel. It had been forced into bankruptcy during the Gulf War in 1991, when the airline industry had previously taken a serious war-related hit. Although America West had largely recovered from that episode and now has one of the lowest cost structures in the industry, it had management problems in 2000 and 2001 that it was trying to correct. Furthermore, America West had lost $55 million in the first half of 2001 as a result of declining traffic in the early months of the recession.[92] The collapse in traffic after September 11 sent it reeling. The company's cash reserves began shrinking at the rate of more than $1 million per day, and it could not raise more money.[93] Although America West received $98 million of the total $5 billion in immediate cash payments to air carriers under the Act, some analysts were predicting that, without further federal aid, the airline would run out of cash and have to seek bankruptcy protection before the end of the year.

America West's precarious financial position, ironically, made it even harder

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90. The subsidization and direct provision of war-risk liability insurance under the ATSSSA has been controversial for a different reason, however, because insurance carriers who would like to sell insurance to the airlines have complained that the federal government ought not to be in this business. Since two other papers in this special issue deal with the economics of war-risk insurance, I will not consider that debate in this Article. *See* Anne Gron & Alan O. Sykes, *Terrorism and Insurance Markets: A Role for the Government as Insurer?*, 36 IND. L. REV. 447 (2003); Jeffrey E. Thomas, *Exclusion of Terrorist-Related Harms from Insurance Coverage: Do the Costs Justify the Benefits?*, 36 IND. L. REV. 397 (2003). Curiously, the limits on liability established under the ATSSSA have also not been controversial, even though these limits are worth much more to the larger airlines than to small airlines.

91. Air Transportation Stabilization Board, *What's New?*, *at* http://www.ustreas.gov/atsb/whatsnew.html (last visited Oct. 17, 2002).

92. A new president had taken the helm of America West on September 1, 2001, and by September 10 the airline had negotiated, but not yet closed, on a $200 million financing package. After September 11, the financing fell through. *See* Hal Mattern, *America West at Crossroads*, GANNETT NEWS SERV., Dec. 30, 2001; Melanie Trottman, *Credit Lifeline: Still Wobbling a Bit, America West Tests Plan to Help Airlines*, WALL ST. J., April 4, 2002, at A1.

93. Caroline E. Mayer & Frank Swoboda, *Airline Agrees to Offer U.S. a Stake for Aid; America West Bid May Set Industry Pattern*, WASH. POST, Dec. 11, 2001, at A1.

for it to get financial aid under the terms of the ATSSSA and associated rules. These terms and rules, somewhat contradictorily, were supposed to provide financial assistance to airlines that could not get sufficient financing in the private markets. However, the financial assistance was not supposed to apply to firms that were already in bankruptcy as of September 11, 2001, or that would probably have gone into bankruptcy proceedings even if the terrorist attacks had not occurred.[94] There is some evidence that larger, healthier airlines may have been quietly lobbying the ATSB to let America West fail.[95]

In its initial application, America West sought $400 million in credit guarantees (which it hoped would form the basis of a total new financing package of $1 billion), but it soon became clear the members of the ATSB were not eager to issue a loan guarantee[96] and would make stringent demands on any airline that sought them.[97] On December 7, 2001, America West filed an amended application that increased from $426 million to $445 million the amount of the loan it was trying to get, but still sought a guarantee for only $400 million (just under 90%) of that loan. The revised application also used more conservative assumptions about future business conditions and increased the amount of other financing it pledged to get from others, the amount of concessions it promised to get from other stakeholders, and the compensation it would pay to the government (in the form of cash, fees, and warrants) in exchange for the loan guarantees.[98] The application also included warrants that would give the U.S. government the right to buy up to 10% of America West's outstanding stock at $6 per share.[99] "The message was: You need to prove you have a viable business plan and need to be willing to pay taxpayers for the risk they are taking," America West's chairman, W. Douglas Parker, told *The Washington Post*.[100]

The ATSB was still not satisfied.[101] The company then reduced to $380 million the amount it was asking the government to guarantee, representing 85%

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94. Mark Moran, *American West Airline Offers Government Part Ownership in Return for Federal Loan Guaranty*, NAT'L PUB. RADIO, Dec. 11, 2001. Of course, US Airways did go into bankruptcy proceedings as of Aug. 11, 2002, but the ATSB has continued to negotiate with the company throughout the bankruptcy proceedings. *See supra* notes 14-15 and accompanying text.

95. Trottman, *supra* note 92, at A1.

96. Aviation Daily reported that two of the three ATSB members—the Federal Reserve representative and the U.S. Treasury Dept. representative—opposed giving America West any aid. *America West Submits Amended Loan Guarantee Application*, AVIATION DAILY, Dec. 11, 2001, at 3.

97. Mayer & Swoboda, *supra* note 93, at A1.

98. *America West Submits Amended Loan Guarantee Application*, *supra* note 96, at 3. Aviation Daily also reported that an America West negotiator claimed that the "fee structure mirrors a private commercial loan it negotiated just prior to Sept. 11." *Id.*

99. Mayer & Swoboda, *supra* note 93, at A1.

100. *Id.*

101. Caroline E. Mayer, *America West Again Revises Bid for Aid; Airline's Action Is Focus of Fight Over U.S. Role*, WASH. POST, Dec. 19, 2001, at E1.

rather than 90% of the financing it was seeking, and found another outside lender that would supply an additional $20 million.[102] It also increased the amount of concessions it was seeking from aircraft manufacturers and lessors, offering to give these companies convertible debt securities and warrants that together could give them the rights to up to 40% of America West's Class B common stock.

The seven-year business plan laid out in the application, and in filings made with the SEC in connection with the issuance of the convertible debt and warrants, indicated that America West had negotiated with lessors to immediately retire fourteen aircraft, or 9.3% of its fleet, and to defer deliveries of twenty-five new aircraft the company had ordered for delivery between 2001 and 2004, in order to spread out receipt of those planes through 2007.[103] Under the plan, the loans, which America West was hoping the government would guarantee, would be paid off between 2005 and 2008.

Finally, on the evening of December 28, 2001, the ATSB announced that it had approved America West's loan guarantee, conditioned on the airline further increasing the compensation the government would receive in the form of additional "warrants that represent [thirty-three] percent of AWA's common stock on a fully diluted basis, with a strike price, expiry date, anti-dilution provisions, and other provisions protective of the taxpayers' interest, acceptable to the Board."[104] (The warrants ultimately issued were for America West Class B common stock, which had a $3 exercise price and an exercise period of ten years.)[105] The guarantee was also conditional on America West committing to keeping its labor costs under control.[106] Even with this additional compensation, the guarantee had been approved by only a two-to-one vote, with the Treasury representative opposing the deal. Treasury Undersecretary Peter R. Fisher, who served as the Treasury representative on the Board, issued a prepared statement saying, "I fear that the board's decision is likely to impede, rather than promote, real progress toward a safe, efficient, and viable air transportation system for our country."[107]

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102. Caroline E. Mayer, *America West Trims Request for U.S. Aid; Loan-Guarantee Bid Cut by $20 Million*, WASH. POST, Dec. 20, 2001, at E3.

103. Mary Schlangenstein, *America West Details Concessions for Loan Guarantees*, BLOOMBERG NEWS, Dec.20, 2001.

104. Letter from Roger Kodat, Acting Executive Director of the ATS Board, to W. Douglas Parker, Chairman, President and CEO of America West (Dec. 28, 2001), Off. of Pub. Aff. News Release PO-890 (Dec. 28, 2001) (announcing the conditional approval).

105. America West also has a small quantity of Class A common stock, nearly all of which is in the hands of a private investment company. Class A common stock are entitled to fifty votes per share; therefore, voting control of the company lies with this investment company. *See* Press Release, America West Holdings Corp., America West Satisfies Loan Guarantee Conditions, (Jan. 14, 2002) (on file with author).

106. *Id.* America West pilots were already the lowest paid among major carriers. Mattern, *supra* note 92.

107. Michele Heller, *Citi Takes Lion's Share of Loan for America West*, AMERICAN BANKER, Jan. 2, 2002, at 4.

By that time, America West had only five days until it was due to make debt payments, totaling an estimated $87 million,[108] which it would be unable to make without the new financing that the guarantee would secure. With its back against the wall, and facing bankruptcy proceedings unless it accepted the terms, America West agreed.

As part of the financing package, the airline had also negotiated about $600 million worth of concessions and contributions, including reduced or stretched-out payments to aircraft lessors, creditors and vendors, and tax breaks from state and local authorities.[109] Including all the fees and other conditions, the terms of the financing package provide a total return to U.S. taxpayers that, according to America West president Parker, are well in excess of the terms of a private commercial loan that America West had negotiated in August 2001, but which it had never closed due to the terrorist attacks.[110]

Other airline companies had been watching America West's experience closely, and in the first few days after the ATSB issued its letter conditionally promising a loan guarantee, press reports indicated they were rethinking plans to apply for financial assistance. "Most airlines are looking at this as a rough guide, and they don't like what they saw," the *New York Times* quoted aviation analyst Raymond Neidl as saying about the America West agreement.[111] As of late spring 2002, only three other airlines—all of them small—had bothered to apply for loan guarantees. These airlines included Kansas City-based Vanguard Airlines Inc., Frontier Flying Service, Inc., a commuter carrier that serves Alaska, and Miami-based Spirit Airlines. The major airlines, it seemed, had come to the conclusion that going through the effort of trying to get the ATSB to approve a loan guarantee did not have significant advantages for any of the parties involved in the airlines (management, employees, creditors, and shareholders) relative to a trip through Chapter 11 bankruptcy proceedings or even a private restructuring outside of bankruptcy court.[112]

VI. PICKING WINNERS AND LOSERS

Of the major airlines, both US Airways, the sixth largest U.S. carrier, and United Airlines, the second largest, had been mentioned regularly by the media during the fall and winter as likely candidates for financial support,[113] although

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108. Lou Whiteman, *America West Pays Dearly for Loan Guarantees*, DAILY DEAL, Dec. 31, 2001.

109. Caroline E. Mayer & Frank Swoboda, *U.S. to Back Loans to Struggling Airline*, WASH. POST, Dec. 29, 2001, at A1.

110. *New Labor Clause in Bailout Hard to Find*, AIRLINE FIN. NEWS, Jan. 7, 2002.

111. Micheline Maynard, *Airlines Shy Away From Loan Guarantees by U.S.*, N.Y. TIMES, Jan. 3, 2002, at C1.

112. One industry analyst called the terms "a pact with the devil." *See* Whiteman, *supra* note 108 (quoting Michael Boyd, an Evergreen, Colorado-based aviation consultant).

113. *See, e.g.*, Keith L. Alexander, *Airline May Seek Loan Guarantee: US Airways CEO Hints at Hope That Employees Will Take Pay Cuts*, WASH. POST, Mar. 27, 2002, at E3; Keith L.

throughout the spring neither airline filed any official request for financial help with the ATSB. Of these two, US Airways was in a far weaker immediate cash flow position. The airline lost nearly $2 billion in fiscal year 2001,[114] had only $561 million in cash available to it at the end of March 2002, and was losing about $3.5 million per day.[115] The airline also had virtually no assets that could be used for collateral.[116] United, by contrast, ended the first quarter with $2.9 billion in liquidity and had $2.5 billion to $3 billion in unencumbered modern aircraft that could be used as collateral for loans.[117] It was burning through about $5 million a day in expenses in excess of revenues.[118] United, however, faces about $1 billion in debt repayments due at year-end 2002, and in early 2003. Both airlines talked publicly of filing for a loan guarantee as part of their negotiations with unions to get labor costs down.[119] However, neither airline actually filed. Perhaps both were hoping that air travel would pick up again, as evidence appeared that the economy had moved out of recession, and thereby rescue them from having to restructure to suit the ATSB.

Nevertheless, while air travel in general did increase somewhat during the spring, the nature of the market appeared to have changed. Business travelers had traditionally provided the bulk of revenues for the major airlines because they had been willing to pay higher fares to avoid overnight Saturdays or other restrictions.[120] But as business and leisure travel began increasing in the spring,

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Alexander, *United Expected to Seek U.S. Aid*, WASH. POST, Feb. 2, 2002, at E1 [hereinafter Alexander, *United Expected to See U.S. Aid*].

114. Keith L. Alexander, *US Airways to Defer Payments; Debt Move Called a Step in Carrier's Restructuring Effort*, WASH., POST, July 2, 2002, at E2.

115. Keith L. Alexander, *US Airways Applies for Federal Assistance*, WASH. POST, June 11, 2002, at E1.

116. *Id.*

117. *United Airline Mechanics Key to Loan Guarantee Quest*, AIRLINE FIN. NEWS, July 1, 2002; *see also* Eric Torbenson, *D.C. Test for Airlines*, ST. PAUL PIONEER PRESS, June 30, 2002, at 1D.

118. Keith L. Alexander, *United Asks U.S. for Loan Guarantee*, WASH. POST, June 25, 2002, at E1.

119. *See* Alexander, *United Expected to Seek U.S. Aid*, *supra* note 113, at E1 (noting that United's attempt to regain financial health without going to the government has faltered, and its efforts to win major union concessions stalled); Susan Carey, *US Air Chief Unveils Recovery Plan*, WALL ST. J., May 17, 2002, at A2 (describing US Airways' plans to cut labor costs by $1 billion per year, obtain $200 million per year in annual concessions from lenders and suppliers, and secure a $1 billion federal loan guarantee); Susan Carey, *US Airways Signals It May Ask Workers to Accept Pay Cuts*, WALL ST. J., Mar. 26, 2002, at A2 (noting that both US Airways and United Airlines were asking workers to take pay cuts as part of their decisions about whether to seek federal loan guarantees); Edward Wong, *US Airways Ready to Test Federal Program*, N.Y. TIMES, April 27 (2002)(noting analysts' opinions that US Airways needs to apply for a loan guarantee to use as a negotiating tool to bring down labor costs).

120. Unrestricted fares at the big airlines are typically about four times as much as restricted fares. *See* Trottman & McCartney, *supra* note 50, at A1.

it became clear that business travelers had learned to shop for low fares on the Internet and had become unwilling to pay substantially more than leisure travelers.[121] The old price discrimination revenue model, in which the major airlines captured the business travelers at high fares by offering reliability and a wide range of departure and route options, as compared to the regionals, which operated by offering lower fares but fewer time and route options to leisure travelers, had broken down.[122] The major airlines continued to hemorrhage cash through the third quarter of 2002,[123] with total losses for the industry of nearly $2.5 billion in the third quarter, a period that is usually the season of strongest demand for air travel. Losses for the industry as a whole exceeded industry losses of the third quarter of 2001, which included the immediate aftermath of September 11.[124] Nonetheless, Southwest Airlines had returned to profitability, and several other small airlines were aggressively gaining market share.[125] By mid June, in fact, at least one airlines analyst had estimated that Southwest Airlines, dubbed "the king of the discounters," had "surpassed Northwest Airlines, Continental Airlines and US Airways Group in terms of revenue passenger miles flown domestically."[126]

Then, on June 7, just three weeks before the June 28 application deadline for financial assistance, and less than two weeks after the ATSB had turned away Vanguard Airlines and Frontier Flying Service, US Airways filed an application with the ATSB for a $900 million loan guarantee, to be part of a restructuring package that would include $1 billion in new financing, plus $1.3 billion in cost concessions from employees and vendors.[127] The package also offered an undisclosed equity stake to the government. US Airways' action appeared to

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121. *Id.*

122. The *Wall Street Journal* noted that "American business has changed its flying habits, possibly forever." *Id.*

123. *See* Scott McCartney, *Big Three Airlines Face Tough Tasks,* WALL ST. J., Oct. 24, 2002, at D5 (noting that the three largest airlines, American, United, and Delta, lost a total of $2.14 billion in the third quarter of 2002).

124. *See* John Heimlich, *U.S. Airlines: The Road to Resuscitation*, Air Transport Association, Oct. 31, 2002, fourth slide, headed "Heavy Losses Continuing in 2002," *available at* http://www.airlines.org/public/industry/bin/Econ102.pdf.

125. In May, for example, the nation's largest airlines reported that traffic was still down by about 10% compared with the prior May. But a number of smaller airlines were reporting increased traffic, including Southwest (up 4.4%), ATA (up 5.9%), JetBlue (up 106.4%), AirTran (up 19.2%) and Frontier (up 16.2%). *See The Air Transportation Stabilization Board Will Get Its First Test of the Federal Bailout Law When It Decides Whether United Airlines Deserves a Federal Loan Guarantee*, DETROIT NEWS, June 30, 2002; *see also* Melanie Trottman, *Southwest Airlines Turns More Aggressive: Moves Follow the Successful Outcome of Gamble on Continued Growth After Sept. 11*, WALL ST. J., July 15, 2002, at B6.

126. *See* Trottman & McCartney, *supra* note 50, at A1 (citing UBS Warburg airline analyst Samuel Buttrick).

127. *See* Alexander, *supra* note 115, at E1; Susan Carey & Stephen Power, *Air Loan Board Isn't Afraid to Say No,* WALL ST. J., June 26, 2002, at A2.

spur action by a number of other airlines. On June 24, United Airlines followed, requesting a $1.8 billion loan guarantee as part of $2 billion in new financing.[128] The filing came after United pilots tentatively agreed to a pay-cut agreement worth $520 million over three years if United would apply for federal help, and United management agreed to $430 million in concessions.[129]

US Airways' and United's filings, in turn, spurred a number of regional carriers to file. On June 13, American Trans Air applied. On June 27, Aloha Airlines and Great Plains Airlines applied. Moreover, on June 28, at the last possible moment, Frontier Airlines, World Airways, Corporate Airlines, MEDjet International Inc, and Gemini Air Cargo applied.[130] Frontier officials said they applied for a $59.5 million loan guarantee partly to "ensure that the playing field is level."[131]

The last-minute rash of filings, especially by airlines that appeared to have access to other sources of capital in the capital markets, raised serious questions in the minds of many critics about the role that the airlines seemed to think loan guarantees under the ATSSSA should play.[132] Coming nine-and-one-half months after September 11, with no further terrorist attacks having occurred and the economy apparently recovering, it was hard to make the case that providing loan guarantees to a self-selected subset of the airline industry was "a necessary part of maintaining a safe, efficient, and viable commercial aviation system in the United States."[133] While the promise of financial assistance to prevent airlines from being forced into bankruptcy in the immediate aftermath of September 11 may have been important symbolically to help restore confidence on the part of travelers that the system as a whole would not be allowed to fail, by the summer of 2002 it began to appear that the implicit ability of the ATSB to pick winners and losers could have a substantial impact on the future structure of the airline industry. To selectively award financial aid to some airlines, the government would be "playing God in shaping the future of what the industry looks like," argued Doug Steenland, president of Northwest Airlines, at an industry conference in May.[134] Samuel Buttrick, UBS Warburg analyst, noted that providing financial assistance to some airlines would mean that "winners [would] lose at the margin so losers can win."[135] "What the hell does the taxpayer need

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128. *See* Dave Carpenter, *United Seeks $1.8B Federal Loan*, ASSOCIATED PRESS, June 24, 2002.

129. *Id. See also U.S. Loan for United Airlines Premature*, DETROIT NEWS, June 30, 2002.

130. *See List of Airlines Seeking Aid*, *supra* note 22; *Three Small Airlines Apply for Guarantees on Federal Deadline*, *supra* note 22.

131. Stephen Power, *Four More Airlines Request Loan Guarantees from U.S.*, WALL ST. J., July 1, 2002, at B8.

132. For example, United Airlines had raised $775 million in a private secured financing in January 2002. *See* Carey & Power, *supra* note 127, at A2.

133. General Standards for Board Issuance of Federal Credit Instruments, 14 C.F.R. § 1300.10(a)(3) (2001).

134. Carey & Power, *supra* note 127, at A2.

135. Buttrick et al., *supra* note 52, at 4.

to subsidize (an airline) for if the company can go out and get [financing] in capital markets," asked Continental Airlines CEO Gordon Bethune.[136] On the other hand, others complained that if a company cannot get credit in the public capital markets, perhaps that company should not be saved by government subsidy.[137] The head of an association that represents small airlines complained that by keeping the big carriers with high cost structures alive, the ATSB is crowding out smaller new competitors that have more efficient costs.[138]

Clearly the terrain had shifted, so that by the summer of 2002 the issue at stake in decisions by the ATSB to provide financial assistance to airlines was no longer about keeping the whole airline industry going through a major crisis. The issue had become about how to restructure the airline industry in the face of what appeared to be a significant change in the airline competition model, away from the historic model in which the cost advantage was held by hub-and-spoke operators. Meanwhile, some members of Congress were testing the idea of delaying or cutting the funding available for loan guarantees under the ATSSSA in order to reallocate the funds toward other budget priorities.[139]

The ATSB could have sidestepped the controversy by simply refusing to grant any more loan guarantees, on the grounds that the crisis had passed, and that none of the guarantees were now "necessary" for "maintaining a safe, efficient, and viable commercial aviation system in the United States."[140] However, on July 10, 2002, the ATSB gave conditional approval to US Airways' request, as discussed above,[141] but with stringent conditions demanding more concessions in the form of legally binding agreements with unions, suppliers, and lenders. US Airways was also required to increase the equity stake offered to the government (the amount of which has not been released, but which has been reported to be well below the 33% stake given by America West); resolve outstanding issues surrounding airport slots and gates; and conclude final loan documents,[142] and after August 11, 2002, win approval of the bankruptcy court for its plan of reorganization.[143] By contrast with America West's experience, the rapid approval of US Airways' loan guarantee request suggests that the airline had been in negotiations with ATSB staff for several months leading up to its June 7 filing,[144] so that many of the conditions it would have to meet were

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136. *See* Carpenter, *supra* note 128.

137. Carey & Power, *supra* note 127, at A2.

138. Torbenson, *supra* note 117, at 1D.

139. *See* Carey & Power, *supra* note 127, at A2; *see also* Torbenson, *supra* note 117, at 1D; *House Chairman Fighting to Preserve Loan Guarantees*, AIRLINE FIN. NEWS, July 1, 2002.

140. General Standards for Board Issuance of Federal Credit Instruments, 14 C.F.R. § 1300.10(a)(3) (2001).

141. *See supra* note 15 and accompanying text.

142. Reeves & McKay, *supra* note 12, at A1. *See also* Daniel, *supra* note 12, at 25.

143. *See Air Transportation Stabilization Board's Statement on US Airways' Plan for Chapter 11 Reorganization*, Aug. 12, 2002, *at* http://www.ustreas.gov/press/releases/po3342.htm.

144. Sources inside the ATSB have indicated that "US Airways presented the strongest case of all the airlines that have applied" and "US Airways executives also worked with ATSB staff

already incorporated in the initial filing. In fact, throughout the spring, newspaper articles noted on a number of occasions that US Airways was using the promise (or threat?) of either a loan guarantee filing, or a Chapter 11 filing, or both, in its negotiations with labor over concessions.[145] Moreover, one could argue that US Airways had a stronger case than other major airlines that its devastating losses (more than $2 billion worth) in the previous year were attributable to the terrorist attacks of September 11, because Reagan National Airport in Washington, D.C. is a major hub for US Airways. Reagan National was shut down completely for three weeks after September 11.[146] Moreover, the company reportedly offered the government its valuable landing and arriving slots at New York's LaGuardia Airport and Washington's Reagan National Airport as collateral, as well as its gates at several East Coast airports—all of which can probably be sold easily if US Airways defaults.[147]

Nonetheless, as of the writing of this Article, the ATSB had rejected the applications of United Airlines and four small airlines,[148] and given approval of loan guarantees for two airlines (in addition to American West).[149] So its award of a guarantee to US Airways suggested that, whether it had intended to or not, the ATSB has gone into the business of picking winners and losers in the airline industry restructuring wars.

VII. HAVE AIRLINE ECONOMICS FUNDAMENTALLY CHANGED?

In Part I above we noted that the hub-and-spoke operational structure of the major airlines resulted in complicated economic dynamics for the airline industry. To the extent that hub-and-spoke operations reduce average costs by centralizing maintenance operations and make it possible to coordinate traffic better to keep more planes full, the large hub-and-spoke operators ought to be the low-cost operators, at least when operating at close to full capacity, with all other costs being equal.[150] Moreover, to the extent that hub-and-spoke operations provide positive externalities that enhance the value of other airlines serving the

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members for several months prior to submitting their application last month and even used some of the same financial advisors as America West."). Alexander, *supra* note 12, at E1.

145. *See supra* note 119 and accompanying text.

146. Alexander, *supra* note 117, at E1; *see also* Alexander, *supra* note 12, at E1 (noting that US Airways did make this argument in its application).

147. Alexander, *supra* note 12, at E1.

148. The airlines whose loan guarantee requests have been denied include Frontier Flying Service, Inc. (denied May 31, 2002); Vanguard Airlines, Inc. (denied for the fourth time July 29, 2002); National Airlines, Inc., and Spirit Airlines, Inc. (both denied August 14, 2002). *See* ATSB, *Recent Activity*, *supra* note 11. United Airlines loan guarantee request was denied December 4. *See*

149. Conditional approvals have gone to US Airways, American Trans Air, Aloha Airlines, and Frontier Airlines. *See supra* notes 12, 19-20 and accompanying text.

150. Of course, *supra* note 53 and surrounding text, all other costs are not equal, and the industry as a whole is still operating well-below full capacity.

same hubs, it might be economically efficient to make sure those operators stay in business.

The events of the past year, combined with other factors that have been coming together over the last two decades, have turned airline economics upside down. Smaller, regional carriers and discount operators, such as Southwest, Frontier, and JetBlue, as well as the restructured America West, are now clearly the low-cost operators. Discount operators have long had labor cost advantages relative to the big seven.[151] However, the big airlines have had the cost savings presumably provided by hub-and-spoke operations, and they have been able to attract the high marginal value travelers (especially business travelers) by offering more flight times and more destination options. Hence there has been room in the market for both kinds of operators during periods of air travel expansion, such as much of the 1990s.

Since early 2001, however, air travel has fallen off more so than in any of the previous recessions.[152] The effect has been particularly hard on hub-and-spoke operators because the high fixed costs associated with their operations have turned into a major cost disadvantage relative to non-hub-and-spoke operators. When these high fixed costs have been combined with the long-standing labor cost disadvantages of the big airlines, the major carriers have simply been unable to meet the price discounts offered by the smaller regional carriers. The price wars now are being initiated by the "wannabes," rather than by the established carriers trying to protect their turf.[153]

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151. American, United, Delta, Northwest, Continental and US Airways have all been in existence since before deregulation in 1978, have older fleets, and older employees who are more likely to be unionized. Only a few of the regional carriers, including Southwest, have been in business that long. As of the third quarter of 2001, Southwest had surpassed US Airways in revenue passenger miles to become the sixth largest carrier. Labaton, *supra* note 46, at C1 (accompanying chart, entitled "Big Airlines, Big Trouble"). Out of fifty-eight new carriers that started operations after deregulation in 1978 and before 1990, only America West is still operating. Morrison & Winston, *supra* note 48, at 9. America West went through bankruptcy restructuring in the early 1990s, and now has one of the lowest labor cost structures in the business. Trottman, *supra* note 92, at A8 (noting that the carrier has "a low cost structure that most other major carriers would envy.").

152. Air Transport Association, *supra* note 69 (comparing percentage decline in traffic in 2001-2002 to percentage declines in previous recessions).

153. The major carriers tried several times in the spring of 2002 to increase their prices, but lost volume so fast that they quickly dropped their prices again. Melanie Trottman, *America West Sparks Airfare War*, WALL ST. J., Apr. 22, 2002, at A3 (noting that the larger airlines had tried twice in the previous two weeks to raise domestic fares). Meanwhile, America West is using the liquidity its new government-backed financing has given it to revamp its business model by dropping fares on the last-minute, unrestricted tickets long preferred by business travelers. *See* Melanie Trottman, *Small Airlines Gain by Cutting Business Fares*, WALL ST. J., July 29, 2002, at B1. The company reports that its business travel revenue trends are improving as a result. "In the first quarter, its revenue per available seat mile from business travelers was down 16% from a year earlier, but narrowed to a drop of only 3% in the second quarter, including a 1% increase in June."

Some substantial part of the overall decline in air traffic is probably still attributable to fear of terrorist attacks and to the increased air travel hassles resulting from enhanced security measures. What is unclear, however, and which cannot be resolved in this Article, is whether there has been a permanent shift in taste and habits of the traveling public—especially business travelers—that works against the business model of the traditional hub-and-spoke operators, or whether the industry is merely still working out the shock waves of the post-September 11 collapse in traffic. The ATSSSA was designed to address the latter, not the former. If the shift in traveler habits is permanent, the industry will have to reorganize itself in response, and it is not at all obvious that it is useful for the ATSB to help some companies make the needed adjustments without providing even-handed help to all companies.

CONCLUSION

Part I above reviewed a number of possible rationales for providing government subsidies to the airline transportation system as a whole, but most of these did not translate into rationales for providing assistance to specific airlines. The exception was the argument that hub-and-spoke operations might be natural monopolies and that they may provide positive externalities to other carriers. However, the events of the last year have called into question whether hub-and-spoke operations are really lower cost in the long run (through both expansions and contractions in air travel), and whether they really provide positive externalities. Absent the hub-and-spoke arguments, there appear to be few, if any, compelling reasons to subsidize selected airlines.

The problem, however, is that the airline transportation system is made up of individual airlines. So any decision to subsidize or shore up the industry as a whole must either grapple with the question of how to subsidize the industry in a way that is neutral as to which airlines get the benefit of the subsidy, or it must pick "winners and losers" by subsidizing some more than others.

The ATSSSA proposed to do some of both. The cash grants and the insurance subsidies probably operated in a neutral way because they were available to all airlines on the same terms, and on a more-or-less pro rata basis according to the volume of business each airline did prior to September 11. Yet the loan guarantee part of the Act required case-by-case negotiations over terms, which inevitably forced the ATSB into the role of deciding which airlines were worth saving, and on what terms. For this reason, the loan guarantee part of the Act was the most controversial from the beginning, and the Bush Administration, which was called upon by Congress to administer the ATSSSA, actively resisted playing the role of banker.

So far, the loan guarantees actually approved by the ATSB suggest that the policy of the Board is to demand terms that are nearly as stringent as (and maybe more stringent than) the airline would face in the private financial markets. The guarantee granted to America West required a restructuring of claims against the

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Id. at B4. Frontier, National, AirTran, and American Trans Air are all taking similar actions.

company comparable to what might have been required in a Chapter 11 restructuring. The offer of a loan guarantee for US Airways did not keep this airline out of bankruptcy, and it remained unclear as of early November whether the airline would be able to re-emerge from bankruptcy, even with a federal loan guarantee. Meanwhile, United Airlines was unable to muster a sufficient amount of concessions from its unions and creditors to satisfy the ATSB and was compelled to file for bankruptcy after the ATSB denied its loan guarantee request.

However, if an ATSB-negotiated restructuring and loan guarantee is simply an alternative to Chapter 11, what is the point? Is it really good public policy for a federal agency to be acting like a banker for the airline industry? In normal times, the answer would clearly be no. But the first few weeks after September 11, 2001, when the ATSSSA was passed, were not ordinary times. They were times that called for real and symbolic acts on the part of the government to increase security and restore the public's confidence in our ability to go on with our lives. Just as it is appropriate for bank regulators to take steps to prevent a run on a troubled bank, it was appropriate for Congress to step in with a few real and symbolic acts to reassure the traveling public that the air transportation system was not going to collapse. The immediate no-strings-attached cash doled out to the airlines can be compared to sending the National Guard in to help clean up after a hurricane; the promise of loan guarantees can be compared to declaring the communities in the path of the hurricane to be Disaster Areas, making the individuals and businesses in the area eligible for federal disaster relief loans. Such decisions are primarily about showing solidarity with the victims, and declaring to ourselves that, as a society, we will not let disaster stop us.

So far, the loan guarantees that have actually been provided by the ATSB appear to have been little more than substitutes for Chapter 11. Thus, in practice, they have mostly provided a symbolic subsidy, not a real one. Yet the cash payments doled out last fall were real, and the promise made last fall of further subsidies, though perhaps only symbolic, probably had real effects. Given the negative connotations and sense of failure associated with reorganization through the bankruptcy courts, it was probably useful symbolically last fall to offer airlines an alternative approach to restructuring that does not carry the stigma of bankruptcy. The ATSSSA has done that. It remains to be seen whether the ATSB can respond to the applications it has received, and still manage to get out of the way and let the airlines reorganize themselves to serve a more cautious, price-conscious market in a way that allows them to make a profit and stay in business.

EXCLUSION OF TERRORIST-RELATED HARMS FROM INSURANCE COVERAGE: DO THE COSTS JUSTIFY THE BENEFITS?

JEFFREY E. THOMAS*

INTRODUCTION

The September 11 attack was "the largest single insured event in history."[1] In the end, insurance companies are expected to pay approximately $50 billion to victims of the attack.[2] This is a huge loss. To put it somewhat in perspective, it is more than eight times what the federal government is expected to pay through the Victims Compensation Program.[3] It is also more than three times the total expected cost of the airline bailout, of which the Compensation program is a part.[4] As one industry observer put it, "[n]o matter how much is written about it, it is hard to overstate the significance of Sept. 11 to the insurance industry."[5]

In response to the perceived potential of future terrorist losses, many insurers have begun to exclude terrorist-related losses from their policies.[6] In light of the size and uncertainty of future losses, this is understandable. In adopting this

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* Tiera M. Farrow Faculty Scholar and Associate Professor, University of Missouri—Kansas City School of Law. I wish to thank Professor Warren F. Schwartz for organizing the conference at which this paper was first presented, and to thank all the participants for their insights and criticism.

1. Jeff Woodward, *The ISO Terrorism Exclusions: Background and Analysis*, IRMI INSIGHTS, Feb. 2002, *available at* http://www.irmi.com/insights/articles/woodward006.asp.

2. *See Terrorism Insurance: Rising Uninsured Exposure to Attacks Heightens Potential Economic Vulnerabilities: Before the House Subcomm. on Oversight and Investigations, Comm. on Fin. Servs.* (Feb. 27, 2002) (testimony of Richard J. Hillman, Director, Financial Markets and Community Investment), *available at* http://www.gao.gov [hereinafter Hillman testimony]. Estimates of the insured losses from the Sept. 11th attack are still uncertain and variable, ranging from $30 million to as much as $90 billion, with consensus estimates in the range of $36-$54 billion. *See Need for Federal Terrorism Insurance Assistance: Before the House Subcomm. on Oversight and Investigations, Comm. on Fin. Servs.* (Feb. 27, 2002) (testimony of Mark J. Warshawsky, Deputy Assistant Secretary for Economic Policy, U.S. Treasury), *available at* 2002 WL 2011117 [hereinafter Warshawsky testimony]; Press Release, Swiss Re, Terrorist Attack in New York Causes Record Losses for Property Insurers in 2001 (Dec. 20, 2001), *available at* http://www.swissre.com.

3. "The government estimates the [Victims Compensation] program will cost about $6 billion." Bob Van Voris, *Lawyers Take Over Ground Zero*, NAT'L L.J., Mar. 8, 2002, *at* http://www.law.com.

4. "The September 11 Victim Compensation Program is part of a $15 billion airline bailout passed in September." *Id.*

5. *What Makes Terrorism Different?: Insurers Must Demonstrate How Terrorism Is Distinct from Other Violent Perils*, 26 VIEWPOINT No. 3, Winter 2002, *available at* http://www.aais.org [hereinafter *What Makes Terrorism Different?*].

6. *See, e.g.*, Woodward, *supra* note 1; Jim Carroll, *Terrorism Insurance Much Harder to Find After Sept. 11th*, ERIE TIMES-NEWS, Mar. 10, 2002, *at* 2002 WL 15912668.

approach, however, it appears that little thought has been given to the transaction costs associated with the exclusion. One of the significant contributions of Law and Economics to legal literature has been to illuminate the importance of transaction costs in making normative and policy decisions.[7] This Article applies that contribution to the insurance industry's response to the September 11 attack. It contends that the transaction costs associated with the terrorism exclusions will be so great that they will seriously erode, and perhaps outweigh, the benefits to be derived from the exclusion.

This Article begins with a brief description of the events leading up to the adoption of the exclusion and an outline of the basic provisions of the exclusion. It then develops a simple quantitative model to illustrate and evaluate the potential transaction costs from the use of the exclusion. The final section of the Article will identify insights and conclusions that can be drawn from the model.

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7. The importance of transaction costs was brought to light in the seminal work of Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). By first looking at a world of no transaction costs, Coase shows that legal rules have little or no effect, which has come to be known as the Coase Theorem. This theorem has been the subject of much commentary and critique. *See, e.g.*, Guido Calabresi, *Transaction Costs, Resource Allocation and Liability Rules-A Comment*, 11 J.L. & ECON. 67 (1968); Robert Cooter, *The Cost of Coase*, 11 J. LEGAL STUD. 1 (1982); Allan C. DeSerpa, *The Pure Economics of the Coase Theorem*, 18 E. ECON. J. 287 (1992); H.E. Frech III, *The Extended Coase Theorem and Long Run Equilibrium: The Nonequivalence of Liability Rules and Property Rights*, 17 ECON. INQUIRY 254 (1979); G. Warren Nutter, *The Coase Theorem on Social Cost: A Footnote*, 11 J.L. & ECON. 503 (1968); Donald H. Regan, *The Problem of Social Cost Revisited*, 15 J.L. & ECON. 427 (1972). An overview of this literature can be found in STEVEN G. MEDEMA, RONALD H. COASE 82-90 (1994). Nevertheless, many commentators have missed the point of transaction costs. *See* Robert C. Ellickson, *The Case for Coase and Against "Coaseanism,"* 99 YALE L.J. 611 (1989). A careful reading of Coase "reveals that the set of ideas which have come to be known as the Coase Theorem was not an end, but a means." Steven G. Medema, *Through a Glass Darkly or Just Wearing Dark Glasses? Posin, Coase, and the Coase Theorem*, 62 TENN. L. REV. 1041, 1043-44 (1995). It was a means to move economics away from the Pigouvian approach of government intervention to address externalities, *see id.*, and to consider a world where transaction costs are important to cost-benefit analysis. *See id.* at 1056. To put it differently, "[t]he importance of transaction costs in economic activity has been one of the dominant themes of Coase's work and is, in fact, a common theme that links *The Problem of Social Cost* with the other Article cited by the Royal Swedish Academy in awarding Coase the Nobel Prize, *The Nature of the Firm*." *Id.* at 1046. Indeed, by Coase's own account, the focus on transaction costs has been characterized as his "contribution" to economics. Ronald H. Coase, *The Institutional Structure of Production*, 82 AM. ECON. REV. 713, 713 (1992). Although not quite as controversial, the transaction costs point has also been subject to criticism. *See, e.g.*, Pierre Schlag, *The Problem of Transaction Costs*, 62 S. CAL. L. REV. 1661 (1989).

I. BACKGROUND

A. Cost of September 11 in Context

Understanding the scope of the losses caused by the September 11 attack in context will help explain the insurance industry's adoption of the terrorist exclusion. The fact that it was the largest insured event in history does not fully convey the significance of the losses. The losses caused by the September 11 attack were proportionately much larger than previous catastrophes. Depending on which estimate is used, the insured losses from the September 11 attack were at least *double* the next largest loss in history, and could be as much as *five times greater*.[8] The next four largest single-event losses were Hurricane Andrew (1992 - $15.5 billion), the Northridge Earthquake (1994 - $12.5 billion), Hurricane Hugo (1989 - $4.2 billion) and Hurricane Georges (1998 - $2.9 billion).[9] Assuming the loss figure of $50 billion for the September 11 attack, the following chart shows the proportional differences between the five largest single-event losses in insurance history:

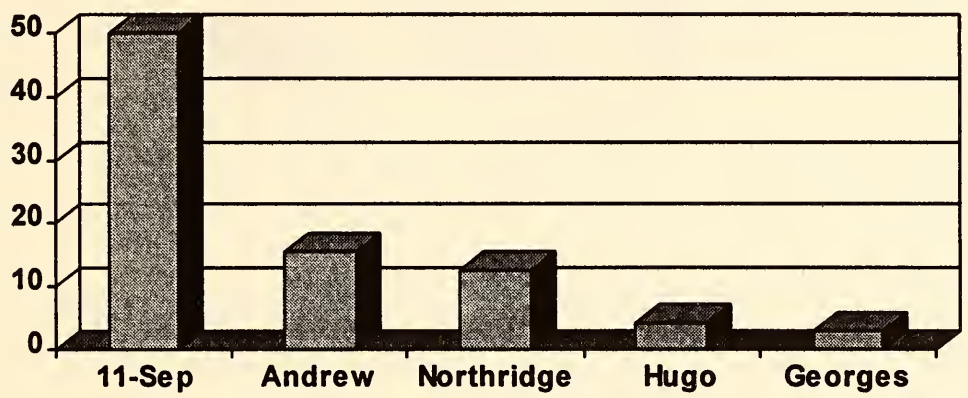

Chart 1 – Five Largest Single-Event Insurance Losses (in billions)

It is noteworthy that the other large, single-event losses are all natural disasters. Man-made disasters have generally not been among the most significant losses. The two largest man-made disasters prior to the September 11 attack caused damages of $3 billion (the 1988 explosion of the Piper Alpha drilling platform) and $2.9 billion (the 1989 explosion of a petrochemical factory in Texas).[10] When comparing the size of losses from man-made disasters, the

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8. Hurricane Andrew caused $15.5 billion in insured losses. Robert P. Hartwig, *The Long Shadow of September 11: Terrorism & Its Impacts on Insurance and Reinsurance Markets*, *at* http://www.iii.org/media/hottopics/insurance/sept11/content.print (July 25, 2002). This is compared to between $30 billion and $90 billion in insured losses for the September 11 attack. *See* Warshawsky testimony, *supra* note 2.

9. This data comes from the Senior Vice President and Chief Economist of the Insurance Information Institute. *See* Hartwig, *supra* note 8.

10. *See* Swiss Re, *supra* note 2.

September 11 damages take on even greater significance. Damages from the attack were at least *ten times greater*, to as much as *thirty times greater*, than the next largest man-made disaster.[11] The following chart illustrates the difference:

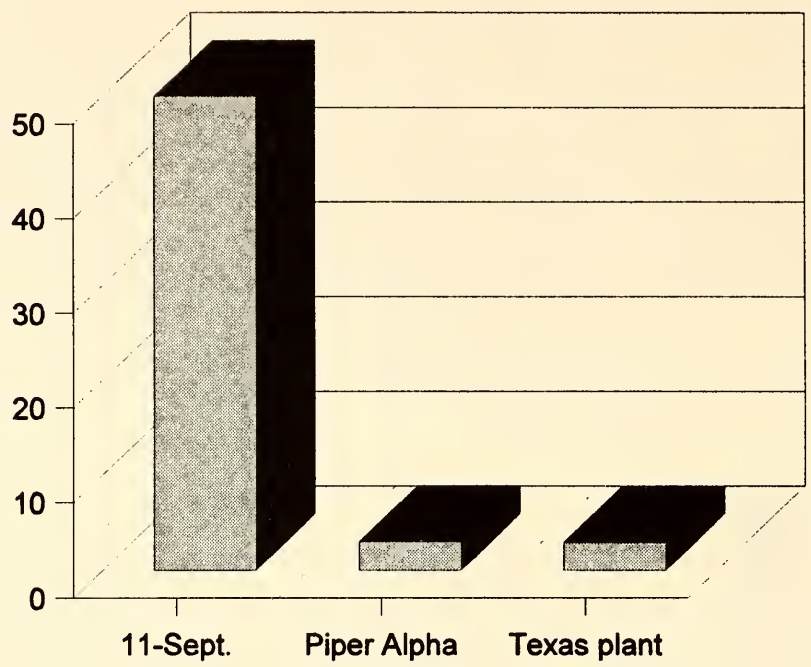

Chart 2 – Three Largest Man-Made, Single-Event Insurance Losses
(in billions)

Finally, not only were the September 11 losses extraordinary in their size, but they also were widely distributed throughout the insurance industry. Although the property/casualty market will bear a large proportion of the losses, substantial amounts are being paid for claims under workers compensation insurance, life insurance, and liability insurance. The Insurance Information Institute estimates the following distribution of losses: property insurance, 22%; aviation hull, 1%; business interruption, 26%; event cancellation, 3%; worker's compensation, 10%; life insurance, 16%; aviation liability, 9%; other liability, 13%.[12] The following chart presents this data in a graphic format:

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11. The damages of $3 billion were compared to between $30 billion and $90 billion in insured losses for the September 11 attack. *See* Swiss Re, *supra* note 2; *see also* Warshawsky testimony, *supra* note 2.

12. *See* Hartwig, *supra* note 8. It should be noted that these percentages are based on an estimated total loss of approximately $40 billion. The distribution, of course, may turn out to be different.

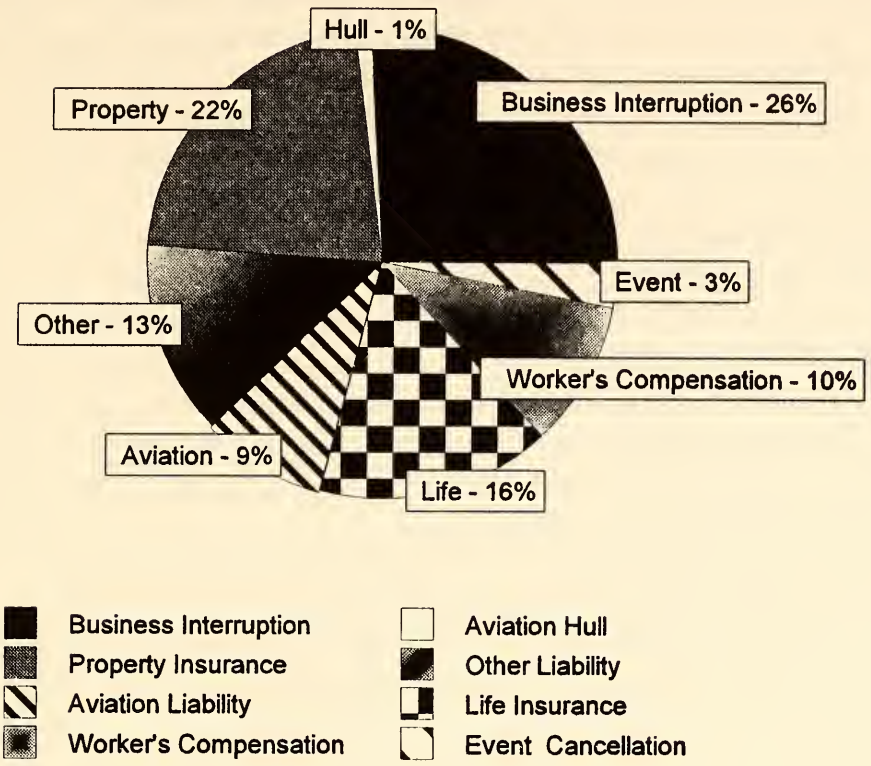

Chart 3 – Distribution of Losses Over Different Types of Insurance

B. The Industry Response

The September 11 attack radically altered the way the U.S. insurance industry handles terrorist-related risks. Prior to the attack, terrorist-related losses were sufficiently small and infrequent that insurers did not take them into account when underwriting risks.[13] The industry had not conceived of an attack that could generate such astronomical losses.[14] Now insurers are keenly aware of real and potential losses, accompanied by their inability to calculate the probable risk. As a result, most insurers consider terrorist risks "uninsurable" from an underwriting perspective.[15] They believe that uncertainty about the probability of a future attack and the amount of damages it could cause make it impossible to calculate an appropriate premium for such coverage.[16]

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13. *See* Press Release, Munich Re, *11th September 2001*, §§ 3.3-3.4 (Oct. 18, 2001); Warshawsky testimony, *supra* note 2; *see also Testimony of New York State Insurance Department: Before the House Subcomm. on Oversight and Investigations, Comm. on Fin. Servs.* (Feb. 27, 2002) (testimony of Gregory V. Serio, Superintendent of Insurance), *available at* http://www.ins.state.ny.us [hereinafter Serio testimony]; Hillman testimony, *supra* note 2, at 3.

14. *See* Munich Re, *supra* note 13, § 3.4.

15. *See* Warshawsky testimony, *supra* note 2; Serio testimony, *supra* note 13, at 25-26; *What Makes Terrorism Different?*, *supra* note 5.

16. *See* Hillman testimony, *supra* note 2, at 3; *see also Terrorism Uninsurable*, INS. DAY,

After September 11, terrorism risks became basically uninsurable from the perspective of many insurers. Consequently, the industry sought federal legislative intervention. The industry wanted the federal government to provide a "back-stop" to limit the potential impact of future catastrophic losses. Several different proposals were considered,[17] though only the House proposal made it to a vote in 2001.[18] The House bill authorized government loans to assist in paying losses due to large-scale terrorist attacks.[19]

The Senate adopted its own version of a federal "back-stop" in June 2002, and authorized the federal government to essentially reinsure catastrophic terrorism-related losses.[20] Under the Senate bill, the government would pay for 80% of terrorism losses up to $10 billion, and then would pay 90% of losses over $10 billion. Insurers would bear a portion of the losses based on their share of the market.[21] A compromise version along the lines of the Senate bill, known as the Terrorism Risk Insurance Act, was passed in November 2002, and signed into law by President Bush on November 26.[22]

The Terrorism Risk Insurance Act "requires the federal government to pay 90% of the cost of an attack by foreign terrorists after losses are greater than $10 billion up to a total of $100 billion.[23] As a condition for such federal support, insurers are required to begin offering terrorism coverage immediately.[24]

When it became clear that legislative assistance would not be available by the end of 2001, however, the industry started to exclude terrorism-related losses from coverage.[25] Reinsurers were the first to adopt such exclusions, in part

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Feb. 21, 2002, at 1, *available at* http://www.insuranceday.com.

17. *See, e.g.*, Stephen Labaton, *A Nation Challenged: The Legislation; House Committee Approves Measure to Aid Insurance Industry in Terrorist Attacks*, N.Y. TIMES, Nov. 8, 2001, at B7; Stephen Labaton, *A Nation Challenged: The Aid Bill; White House and Key Senators Revise Proposal on Aid to Insurers*, N.Y. TIMES, Oct. 27, 2001, at B1; Stephen Labaton & Joseph B. Treaster, *Bush Details Plans to Help Insurers on Future Terror Claims*, N.Y. TIMES, Oct. 16, 2001, at C1; Stephen Labaton & Joseph B. Treaster, *A Nation Challenged: The Insurers; Government Role at Issue In Proposal to Help Industry*, N.Y. TIMES, Oct. 12, 2001, at C4.

18. *See Pending Legislation, Terrorism Insurance,* AMERICAN BANKER, Feb. 14, 2002, *available at* 52002 WL 4100042.

19. *See* Stephen Labaton, *A Nation Challenged: The Liability; House Votes to Shield Insurers and Limits Suits by Future Terror Victims*, N.Y. TIMES, Nov. 30, 2001, at B8.

20. *See, e.g.*, Joseph B. Treaster, *Senate Passes Aid to Insurers on Terrorism*, N.Y. TIMES, June 19, 2002, at C1.

21. *Id.*

22. Pub. L. No. 107-297, §§ 101-108, 201, 301, 116 Stat. 2322 (2002). *See* Elizabeth Bumiller, *Government to Cover Most Costs of Insurance Losses in Terrorism*, N.Y. TIMES, Nov. 27, 2002, at A1.

23. *See* Bumiller, *supra* note 22. When losses are less than $10 billion the federal government will pay for losses in excess of a percentage of the insurer's direct earned premiums. Terrorism Risk Insurance Act of 2002 § 102(7).

24. *See* Bumiller, *supra* note 22; *see also* Terrorism Risk Insurance Act of 2002 § 103(c).

25. *See What Makes Terrorism Different?*, *supra* note 5.

because they bore about two-thirds of the losses from the September 11 attack.[26] Because reinsurers are international in character, conduct business worldwide, and deal exclusively with sophisticated insurance companies rather than consumers, reinsurers are subject to more limited regulation and could adopt terrorism exclusions without governmental approval.[27] A majority of reinsurance contracts were renewed in January 2002,[28] and the great majority of them excluded coverage for terrorist-related losses.[29]

The reinsurers' decision to exclude terrorism from coverage left the primary insurers bearing the risk of future terrorist attacks. Without reinsurance, a major loss from a terrorist attack could force many primary insurers into insolvency.[30] According to the National Association of Insurance Commissioners ("NAIC"), a $25 million loss for a single primary property/casualty insurer would threaten the solvency of 886 companies, or 44% of the companies writing commercial property/casualty insurance.[31]

Consequently, the NAIC endorsed a terrorism exclusion for commercial property/casualty insurers.[32] As of February, "45 states and the District of Columbia and Puerto Rico" had approved a standard terrorism exclusion drafted by the Insurance Services Organization,[33] which provides many standard form

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26. *See* Hillman testimony, *supra* note 2, at 8.

27. *See id.* at 3-4; *see also* Jane Kendall, Comment, *The Incalculable Risk: How the World Trade Center Disaster Accelerated the Evolution of Insurance Terrorism Exclusions*, 36 U. RICH. L. REV. 569, 576 (2002).

28. The majority of reinsurance policies expired in January, and by some reports could account for as much as 70% of reinsurance. *See* Hillman testimony, *supra* note 2, at 4 n.2.

29. "Industry sources confirm that little reinsurance is being written today that includes coverage for terrorism." *Id.* at 4; *see also* Warshawsky testimony, *supra* note 2 ("the reinsurance industry has almost entirely stopped assuming terrorism risk"). This trend has been confirmed in surveys. The New York Insurance Department received responses from companies that represented 89% of commercial insurance writings in NY state, and 83% of those companies reported that their reinsurers were excluding or limiting coverage for terrorism. Serio testimony, *supra* note 13, at 20-21. Similarly, the AAIS found that "[m]ore than 80% of the 37 personal lines companies [surveyed] indicated that 'their current or upcoming reinsurance contracts exclude or in some way limit coverage for loss caused by terrorism.'" *AAIS Weighs Action In Wake Of NAIC Decision On Personal Lines Terrorism Exclusions*, AMERICAN ASSOCIATION OF INSURANCE SERVICES, *at* http://www.aais.org.

30. *See* Updates and Releases, Insurance Information Institute, *Terrorism Coverage is a Taxpayer—Not Insurance Company—Responsibility, Industry Forum Told* (Jan. 23, 2002) *at* http://www.iii.org; *California, New York take Big Risks on Terrorism Policies*, NAT'L UNDERWRITER—PROPERTY & CASUALTY—RISK & BENEFIT MGMT., Jan. 2002, at 24, *available at* 2002 WL 9935402.

31. *See* Hillman testimony, *supra* note 2, at 17.

32. *See* News Release, National Association of Insurance Commissioners, NAIC Members Come to Agreement Regarding Exclusions for Acts of Terrorism (Dec. 21, 2001), *available at* http://www.naic.org (last visited Apr. 3, 2002).

33. *See* Hillman testimony, *supra* note 2, at 5. The standard ISO war and terrorism exclusion

policies and endorsements used by the industry. Although the Terrorism Risk Insurance Act, which was enacted in November 2002, requires that commercial property and casualty insurers make terrorism insurance "available,"[34] it does set a price for such coverage.[35] As a result, the cost of terrorism coverage is still too high for many businesses,[36] and therefore terrorism exclusion are still being used.[37]

II. THE TERRORISM EXCLUSION

The initial version of the standard terrorism exclusion was rejected by state regulators as overly broad.[38] The National Association of Insurance Commissioners then facilitated discussions to reach a compromise between the industry and regulators. Because the primary justification for the exclusion was the potential that terrorist-related losses could result in insurer insolvency, the revised exclusion included a threshold requirement before the exclusion would apply.[39] The threshold of $25 million was adopted because a loss of that amount would be a significant threat to the solvency of many primary property/casualty insurers.[40]

A. The Threshold Requirement

The threshold requirement is met if the total losses from a terrorist incident exceed $25 million. For purposes of this threshold, multiple losses are aggregated, and include business interruption losses and all losses from related terrorist incidents within a seventy-two-hour period.[41] Related terrorist events are those that appear to be carried out in concert, or have a related purpose or common leadership.[42] For property insurance, the property damage must take place in the United States, its territories and possessions, Canada, or Puerto Rico

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endorsements for property and commercial liability insurance are included as Appendices A and B.

34. Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, § 103(c), 116 Stat. 2322 (2002).

35. *See* Bumiller, *supra* note 22.

36. *See* Joseph B. Treaster, *Insurance for Terrorism Still a Rarity*, N.Y. TIMES, Mar. 8, 2003, at C1.

37. The Terrorism Risk Insurance Act nullifies such exclusions, *see* Terrorism Risk Insurance Act of 2002, § 105(a), but then allows insurers to "reinstate" the exclusion if the insured refuses to pay the required premium after proper notice, *see id.* § 105(c).

38. *See* Hillman testimony, *supra* note 2, at 16.

39. *Id.* at 16-17.

40. As noted above, *supra* text accompanying note 31, a $25 million loss for a single primary property/casualty insurer would threaten the solvency of 886 companies, or 44% of the companies writing commercial property/casualty insurance. *Id.* at 17.

41. *Id.* at 18-19. For an example of an exclusion for property insurance approved in most states, see App. A.

42. *See* App. A; *see also* Hillman testimony, *supra* note 2, at 19.

to be counted in the aggregate.[43]

The terrorism exclusion developed for liability insurance has a similar threshold provision, though it is different in several respects.[44] The exclusion also uses the $25 million aggregate for property damage, but it is not limited to property damage that occurs in the United States, Canada or Puerto Rico.[45] In addition, the exclusion for liability insurance uses an alternative threshold of fifty or more deaths or serious injuries.[46] Serious injury is defined to include injuries that involve a substantial risk of death, protracted and obvious disfigurement, or protracted loss or impairment of bodily function.[47] Both the economic threshold and the death or injury threshold are to be aggregated for a single terrorist event, or for related events in a seventy-two-hour period.[48]

If the threshold requirement has been met, then none of the losses from the terrorist incident (or related incidents within seventy-two hours) are covered, even the first $25 million in losses.[49] This is quite different than other thresholds typically used in insurance policies. A policy limit, for example, is a threshold requirement that excludes coverage for losses in excess of the limit. Thus, if a policy has a $1 million limit, the insurer will not pay more than that amount, though an insurer will pay up to the limit. The terrorism threshold operates differently. It excludes all losses once the threshold is met.

Some terrorist acts are exempted from the threshold requirement. Terrorist acts that involve nuclear agents are not subject to the threshold requirements.[50] If the terrorist acts involve biological or chemical agents, the threshold does not apply if the acts were carried out by the release of such agents.[51] However, if biological or chemical agents were released unintentionally in the course of a terrorist attack using other means, the thresholds will apply and the losses from the incident are excluded only if the threshold requirement has been met.[52]

B. Act and Intent Elements

In addition to the threshold requirements, the exclusions contain two other elements: 1) the loss must be caused by a certain type of act, which I will call "a terrorist act," and 2) the act must have a terrorist effect or appear to have terrorist intent, which I will refer to collectively as "terrorist intent."[53]

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43. *See* App. A; *see also* Hillman testimony, *supra* note 2, at 19.

44. For an example of an exclusion for liability insurance approved in most states, see App. B.

45. *See id.*

46. *See* App. B at 1; *see also* Hillman testimony, *supra* note 2, at 18.

47. *See* App. B at 1.

48. *See* Hillman testimony, *supra* note 2, at 18-19; *see also* App. B at 2-3.

49. *See* Hillman testimony, *supra* note 2, at 19.

50. *Id.* at 20; *see also* App. B at 1.

51. *See* App. B; *see also* Hillman testimony, *supra* note 2, at 20.

52. Hillman testimony, *supra* note 2, at 20.

53. The exclusions do not use the term "intent," but instead refer to the "effect" of the act or

The terrorist act element is very broad. To satisfy this element of the exclusion, the act need only be one of the following: use or threat of force or violence, commission or threat of a dangerous act, or commission or threat of an act that interferes with or disrupts an electronic, communication, information or mechanical system.[54] This definition is so broad that it includes any violent crime, vandalism or Internet hacking, and may include any action that has a risk of injury (as a "dangerous" act).

The terrorist intent element is also very broad. The intent element is satisfied if the "effect" of the act "is to intimidate or coerce a government or the civilian population or any segment thereof," or is "to disrupt any segment of the economy."[55] Alternatively, if the act does not have that effect, the intent element is satisfied if it "appears that the intent [was] to intimidate or coerce a government, or to further political, ideological, religious, social or economic objectives or to express (or express opposition to) a philosophy or ideology."[56] Thus, terrorist intent will be found if the act causes intimidation or coercion, if that was its purpose, or if the motive falls into six very broad categories (political, religious, social, economic, philosophical, or ideological).

The following table summarizes the elements of the terrorist exclusions:

Table 1 – Elements of Terrorist Exclusions

Required to Make the Terrorism Exclusion Applicable	
Threshold	> $25 million in property damages, including business interruption, from a single event or related events in 72 hours, or
	> 50 deaths or serious injuries from a single event or related events in 72 hours (liability insurance only), or
	a nuclear, biological, or chemical release.
Terrorist Act	use or threat of use of force or violence, or
	commission or threat of a dangerous act, or
	commission or threat of an act that interferes with electronic, communication, information or mechanical systems.
Terrorist Intent	effect to intimidate or coerce, or
	effect to disrupt any segment of the economy, or
	appears that intent was to intimidate or coerce, or
	appears that intent was to further political, ideological, religious, social or economic objectives, or
	appears that intent was to express (or express opposition to) a philosophy or ideology.

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the "apparent intent." Although a terrorist effect (i.e., intimidation or coercion) is not technically terrorist intent, I refer to this as "intent" because the element is a surrogate for intent, though it is broader than traditional intent. *See* Hillman testimony, *supra* note 2, at 17-18.

54. *See id.* at 17; *see also* App. A at 1; App. B at 3.

55. Hillman testimony, *supra* note 2, at 18; *see also* App. A at 2; App. B at 3.

56. Hillman testimony, *supra* note 2, at 18; *see also* App. A at 2; App. B at 3.

III. TRANSACTION COSTS AND A MODEL

A. Conceptual Description of Transaction Costs

These elements of the terrorist exclusions, combined with the nature of a claim for insurance coverage, will likely result in substantial transaction costs. As the losses incurred by the September 11 attack demonstrate, the amount at stake can be very large. As a consequence, insurers will have an incentive to assert the exclusion as a defense.[57] As a general matter, parties are willing to invest more in the preparation of their cases when more is at stake.[58] This incentive effect will be magnified because the exclusion provides a complete defense. As a result, the insurer has an extra incentive to undertake discovery and other efforts to see if the exclusion is applicable. If the insurer is undertaking such efforts, the policyholder has a parallel incentive to prevent the application of the exclusion.

Additionally, the vagueness of the terrorism exclusion will increase transaction costs as the parties act on their incentives. Although the definition of a terrorist act is broad enough that it is unlikely to be disputed, establishing "terrorist intent" is likely to be hotly contested. While the particulars of the intent element are also very broad, they involve abstractions that are subject to many possible interpretations. As a result, they will be difficult to apply and to prove. For example, it is difficult to predict how courts will evaluate whether a particular act has the "effect" to intimidate, coerce or disrupt a segment of the economy. How is such an effect to be measured, and how much of an effect will be required to amount to intimidation, coercion or disruption? Such uncertainty will take many years to resolve through common law mechanisms.[59] This legal uncertainty will be compounded by difficulties of proof. Both sides are likely to

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57. Environmental coverage litigation provides a good example of this phenomenon. As Professor Abraham notes, "[M]ass tort and CERCLA coverage claims are rarely paid without dispute. Too much money is at stake, too many other provisions in CGL policies potentially limit or eliminate coverage of mass tort and CERCLA liabilities, and insurers apparently collected so few premium dollars in anticipation of long-tail coverage liability that most policyholders with mega-coverage claims must bring a lawsuit in order to be paid." Kenneth S. Abraham, *The Maze of Mega-Coverage Litigation*, 97 COLUM. L. REV. 2102, 2106 (1997).

58. *See* Charles Silver, *Does Civil Litigation Cost Too Much?*, 80 TEX. L. REV. 2073, 2096 (2002). A RAND study found that the amount at stake and case complexity were the most important determinants of attorney work hours, accounting for about half of the variance. *Id.* (citing and discussing James S. Kakalik et al., *Discovery Management: Further Analysis of the Civil Justice Reform Act Evaluation Data*, 39 B.C. L. REV. 613, 637 (1998)); *see also* Judith A. McKenna & Elizabeth C. Wiggins, *Empirical Research on Civil Discovery*, 39 B.C. L. REV. 785, 793-94 (1998) (finding "discovery incidence and volume to be related to the stakes of the case").

59. This has been the case with uncertainties surrounding coverage issues for environmental claims. *See* Abraham, *supra* note 57, at 2108. These uncertainties can be compounded by choice of law issues. *See id.* at 2110-11.

hire expensive expert witnesses to evaluate the effect of a terrorist act, but it will be hard to predict who will win the "battle of the experts." These legal and factual uncertainties will drive up costs by encouraging litigation rather than settlement.[60]

Alternatively, insurers may try to prove terrorist intent more directly, though this will raise other legal and factual uncertainties. It is unclear how the courts will interpret what constitutes the "appearance" of intent to intimidate or coerce, or to advance religious, social, economic, political or ideological objectives, which increases legal uncertainty.[61] Moreover, even if the standard were more concrete, intent is always difficult to prove from a factual standpoint. In the case of terrorism, this difficulty will be further complicated by the unavailability of evidence. As we have seen in the September 11 attack, much of the evidence may be destroyed by the incident, witnesses as to intent are difficult or impossible to find, and national security concerns may limit access to evidence developed by the government. In addition, although terrorists in the past often took "credit" for incidents, they are less likely to do so in the future due to the intensity of the U.S. response to the September 11 attack.[62]

If the intent element is satisfied, the threshold element will raise its own set of difficulties. In order to calculate whether the threshold has been met, the parties will have to assess their damages, including damages for business interruption (which is complicated on its own), *before* it can be determined whether there is coverage. This reverses the usual order of proof and will result in detailed and expensive damage calculations that are used only to exclude coverage. In addition, the threshold requirement allows the damages to be aggregated. All losses from a single incident, as well as those from related incidents during a seventy-two-hour period, are to be aggregated, regardless of the number of parties or the variety of claims. This will greatly compound the usual damages problems. It will raise additional uncertainties about what damages should count and whether the multiple incidents are related.[63]

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60. *See id.* at 2109.

61. *See supra* note 59.

62. Such complexity will increase the transaction costs. A RAND study found that "high discovery difficulty cases consume about three times as many total lawyer work hours and five times as many lawyer work hours on discovery as low discovery difficulty cases consume." Kakalik et al., *supra* note 58, at 638.

63. This is similar to the complication of adding additional defendants, except that the additional policyholders may not be defendants in a single case. Additional defendants have been found to be a cause of an exponential increase in litigation costs. As Professor Silver explains:

> The existence of multiple potentially responsible parties may also change the shape of the marginal defense cost curve, causing it to decline more slowly than when only a single defendant is named. This effect is predictable because each additional defendant causes the number of inter-party legal relationships to expand algebraically. The formula for determining the number of bilateral relationships running between members of a group is n(n-1)/2, where n is the total number of participants. A lawsuit pairing one plaintiff with one defendant thus involves one legal relationship (2(2-1)/2=1), while in

The threshold element also raises transaction costs by reversing the usual incentives regarding proof of damages. It encourages insurers to expand damages in hopes of meeting the threshold, while policyholders want to limit damages to stay below the threshold. Insurers, in trying to reach the threshold, may allow damages that are higher than they otherwise would be, while policyholders, in trying to avoid the exclusion, may request damages lower than they otherwise would be. This will cause the insurers to pay more in those cases where they do not quite meet the threshold, or may result in policyholders being undercompensated in order to avoid the threshold. Such under or overpayments, as well as the cost of proving them, are part of the transaction costs associated with the litigation.

As this discussion shows, the application of the terrorism exclusion will be very complicated. It requires resolution of highly uncertain legal issues such as what constitutes a terrorist effect and whether an act was done with "apparent" terrorist purpose. Once the legal uncertainty is addressed, the parties also must deal with factual uncertainties because of the difficulty of proving that these standards have been met, and the difficulty of gathering evidence about a terrorist event. Moreover, to meet the threshold requirements, the parties will need to collect substantial evidence on damages from the event (including damages not covered by insurance and business interruption losses). The damages figures must then be tallied and aggregated. Because so much is at stake, and because so many different interested parties will be involved, disputes and arguments will likely arise at each step and level along the way.

This kind of complexity has been shown to be a significant determinant of high litigation costs.[64] One study, for example, found that "high complexity cases consume about four times as many lawyer work hours as low complexity cases."[65] Asbestos cases, which also involve numerous claimants, difficult factual issues and multiple defendants, on average, require 63% of the total costs associated with such claims for litigation expenses.[66]

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a lawsuit involving one plaintiff and twenty defendants—the average number for an asbestos case—the number of bilateral legal relationships is 210 (21(21-1)/2=210).

Silver, *supra* note 58, at 2101(citation omitted); *see also* JAMES S. KAKALIK ET AL., VARIATION IN ASBESTOS LITIGATION COMPENSATION AND EXPENSES 80 (RAND 1984) (finding that "defense expenses per claim increase substantially with the number of defendants").

64. Along with the amount at stake, the complexity of the case is one of the key determinants to the amount of time attorneys devote to a case. *See* Silver, *supra* note 58.

65. *See* Kakalik et al., *supra* note 58, at 637 (a RAND study).

66. *See* Deborah Hensler et al., *Asbestos Litigation in the U.S.: A New Look at an Old Issue*, THE INSTITUTE FOR CIVIL JUSTICE (Aug. 2001). Professor Silver correctly criticizes what he calls the "compensation ratio" as failing to include the costs of payments for unmeritorious claims and the costs of failing to pay valid claims. *See* Silver, *supra* note 58, at 2078-79. Thus, by focusing exclusively on litigation expenses, this approach understates the total transaction costs.

Although the transaction costs appear to be the highest in asbestos cases, at least as compared to other tort claims that have been systematically studied, litigation costs are also high in other areas as well. A RAND synthesis of studies by the Institute for Civil Justice has shown that the litigation

B. A Model to Analyze Transaction Costs

Although we do not know as an empirical matter how much it will cost to litigate the terrorism exclusion, a simple model will help to illustrate and evaluate the potential impact of such costs. This model will not address the terrorist act element because it is so broadly defined that it can be easily satisfied. Instead, the model will focus on terrorist intent and the threshold elements. It will consider the costs associated with those elements in three different terrorist scenarios considered at three different levels of damages. These scenarios will also be weighted by comparative probabilities.

1. Action Scenarios.—The three action scenarios considered by the model are bombings, chemical attacks, and Internet vandalism. The bombing scenario is included to represent the most typical terrorist attack. The chemical attack is included because of concerns that such threats will occur in the future, especially in light of the anthrax incidents. In addition, a chemical attack provides an example of a scenario where the threshold element does not apply. The Internet scenario is included as the least typical scenario, though one that is considered of growing concern as the Internet becomes a more significant part of our economy. It is also included as an example of activity that might be brought within the exclusion that has not been attributed to terrorist activity in the traditional sense. Incidents of computer hacking and the creation and release of computer viruses have become somewhat commonplace, yet those incidents have not been attributed to traditional terrorist activity.

2. Three Levels of Damages.—Each of these scenarios will be considered at three levels of damages designated as high, medium, and low. The high level of damages will be $1 billion, which is well above the threshold requirement, but substantially less than the damages caused by the September 11 attack. The medium level of damages will be $25 million or fifty deaths or serious injuries. This level of damages is used to consider the effect of being at or near the threshold requirement. The low level of damages will be $1 million and ten or

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costs in automobile cases, which tends to include the more simple of tort cases, comprise 48% of the total costs of such cases and 57% of the total costs in non-auto tort litigation. *See* Silver, *supra* note 58, at 2099 (citing and discussing DEBORAH R. HENSLER ET AL., TRENDS IN TORT LITIGATION: THE STORY BEHIND THE STATISTICS 27-28 (RAND 1987)). Professor Silver notes that "[o]ther sources confirm that litigation costs vary systematically across liability areas, with automobile liability cases and workers' compensation cases tending to cost much less to defend per dollar transferred than cases involving medical malpractice, products liability, and other claims against corporations." Silver, *supra* note 58, at 2009 n.112 (citations omitted).

I am unaware of any studies of the litigation or transaction costs associated with insurance coverage litigation, but an internal review of construction defect coverage litigation reveals that 12% to 30% of total recoveries are paid for legal fees in construction defect cases, depending on the amount at stake. *See* Jeffrey E. Thomas, *To Insure or Not to Insure: The Contribution of Insurer Ambivalence to Transaction Costs in Construction Defect Litigation*, *in* DEFECTIVE CONSTRUCTION: CRISIS IN INSURANCE 2-3 (ABA 1997).

fewer deaths or injuries. This level of damages avoids the threshold by being well below $25 million, but damages are still high enough to create an incentive to litigate the coverage issue if it is available.

3. Probability of Losses.—The model also considers the probability of these different levels of losses. As a general matter, the probability of a loss is inversely related to the size of that loss. Low loss incidents are quite common, while catastrophic losses are rare. For purposes of this model, we will assume that the high damage scenario has a probability of 1/1,000,000 (.000001), the medium damage scenario has a probability of 1/10,000 (.0001), and the low damage scenario has a probability of 1/100 (.01).

4. Transaction Costs Expenditures.— Because of the stakes involved, even with relatively low probabilities the parties will be motivated to expend significant resources in litigating the applicability of the terrorist exclusion.[67] For purposes of this model, we will work with the rather conservative assumption that no party will spend more than 10% of the amount at stake in litigating this particular exclusion.[68] To keep the model simple, we will assume two-party litigation with equal incentives and costs. The total maximum transaction costs will therefore be 20% of the amount at stake. The total maximum transaction costs by the level of damages are $200 million for high damages, $5 million for medium damages, and $200,000 for low damages.

The model analyzes two elements of the exclusion: the intent and threshold elements. However, not every element is involved for each scenario at each level of damages. As a result, the transaction cost assumptions have to be adjusted within the maximum to reflect which elements are at issue. At the high level of damages, only the intent element is at issue because the damages of $1 billion far exceed the threshold requirement of $25 million (by forty times). Thus, the model will assume that the transaction costs are half of the maximum for the high level of damages, or $100 million. Once the probability of a high-damage event is taken into account, the weighted transaction costs are $100 ($100 million x .000001)

At the medium level of damages ($25 million), both the threshold and intent elements are at issue for the bombing and Internet scenarios. As a result, the model assumes that the maximum transaction costs will be incurred for those scenarios. The parties must invest additional resources to measure and aggregate damages. In addition, attempts to increase or decrease damages to exceed or come within the threshold will add to transaction costs. Those efforts may artificially increase or decrease damages in cases where the threshold turns out to be inapplicable.

The threshold element does not apply to the chemical attack scenario under the terms of the exclusion, so we assume that litigation over a chemical attack at

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67. *See supra* note 58.

68. Average litigation costs are likely to be much higher than this figure. In relatively simple automobile cases, as much as 48% of total costs can be devoted to litigation expenses. In more complex asbestos cases, the percentage can reach as high as 63%. *See supra* note 66 and accompanying text.

the medium damage level will incur only half of the total maximum possible transaction costs.[69] The transaction costs at the medium level of damages therefore are assumed to be $5 million each for the bombing and Internet scenarios, and to be $2.5 million for the chemical attack scenario. Once the probability of a medium damage scenario is taken into account, the weighted transaction costs for the bombing and Internet scenarios are $500 ($5 million x .0001) and $250 for the chemical scenario ($2.5 million x 0001).

At the low level of damages ($1 million), the threshold element is unlikely to be met because it is twenty-five times higher than the damages. As a result, in the bombing scenario the insurer probably would not pursue a defense based on the exclusion, and the policyholder would not be required to respond. The model therefore assumes that no transaction costs will be incurred for the bombing scenario at the low level of damages.

In the case of Internet damages, however, computer viruses can multiply so quickly and easily, and can be spread so widely over the Internet, that it may be possible to aggregate enough low level damages from Internet vandalism to meet the $25 million threshold. Some transaction costs are therefore likely to be incurred in that scenario, even at low level damages. The likelihood of such transaction costs is lower than in the case of medium level damages, where they are very likely, so the model assumes only half of the maximum possible transaction costs. Thus, transaction costs at the low level for the Internet scenario are assumed to be $100,000. Once the probability of a low damage event is taken into account, the weighted transaction costs are $1000 ($100,000 x .01).

Because the chemical attack scenario is not subject to the threshold requirement, the parties still have incentives to litigate terrorist intent even at the low level of damages. As a result, the model assumes the same proportion of damages as in the other scenarios, or 10%. This puts transaction costs at $100,000 for a low damage chemical attack, and the weighted transaction costs, accounting for probability, at $1000 ($100,000 x .01).

To summarize, at the low level of damages the model assumes no transaction costs for the bombing scenario, transaction costs of 10% or $100,000 ($1000 weighted by probability) for the Internet scenario (two elements each at half the usual cost ratio), and costs of 10% or $100,000 ($1000 weighted by probability) for the chemical scenario (intent element). At the medium level, the model assumes full transaction costs for the bombing and Internet scenarios ($5 million/$500 weighted by probability), and half of the full transaction costs for the chemical scenario ($2.5 million/$250 weighted by probability) because the threshold element does not apply. At the high level, the model assumes that each scenario will incur transaction costs at half of the full level because the threshold element is inapplicable to all three scenarios. The transaction costs at the high level of damages are $100 million, which is $100 when weighted by the

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69. I wish to reemphasize that this is a conservative assumption. It is possible that a party that does not have to meet the threshold requirement will actually devote more resources to the litigation of the intent requirement.

probability of a high-damage event.

5. *Probability of False Positives.*—Finally, the model makes some assumptions about the probability of false positives. By false positives, I mean those cases that are treated as terrorist incidents, meeting the requirements for both terrorist act and intent, but that, in fact, are not due to terrorism. This distinction, of course, begs the definitional question of what constitutes terrorism. Although there is no consensus definition of "terrorism,"[70] I draw a distinction between what I will call "traditional terrorism" and terrorism as defined by the exclusion.[71] I recognize that "traditional terrorism" is necessarily fuzzy at its margins, but my intent is to reference a core understanding consistent with common perceptions and academic definitions. In terms of common perceptions, most people "readily recognize the bombing of an embassy, political hostage-taking and most hijackings of an aircraft as terrorist acts."[72] Such activities also fit an academic definition of terrorism. Starting in 1972, the Rand Corporation began a database of international terrorist incidents. Deciding which incidents to include in the database required the development of a definition, which is essentially "violence, or the threat of violence, calculated to create an atmosphere of fear and alarm in the pursuit of political aims."[73]

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70. "Terrorism is a phenomenon that is easier to describe than define. . . . [N]either the United States nor the United Nations has adopted official definitions of terrorism." Public Report of Vice-President's Taskforce on Combating Terrorism, *in* WHAT IS TERRORISM, OPPOSING VIEWPOINTS PAMPHLETS 17 (1986) [hereinafter Public Report]. For a thorough discussion of the definitional problems, see BRUCE HOFFMAN, INSIDE TERRORISM at 13-44 (1998).

71. It is, of course, an open question as to whether courts would also adopt a definition of terrorism more restrictive than the literal definition used by the terrorism exclusions. There is some indication based on the past interpretation of the war exclusion that courts may adopt a more limited definition using the doctrine of *contra proferentem*. *See* Kendall, *supra* note 27, at 576. If the courts apply the exclusion using a more literal definition, the "false positives" will not be obvious because they will be treated as terrorist incidents under the exclusion even though under a more commonly accepted definition the incidents were not terrorist events. This would affect the numbers and assumptions in the model, making transaction costs appear lower than what the model shows. However, applying a literal definition would actually increase transaction costs rather than reduce them because the substantive payments made for these "hidden" false positives should be included as transaction costs. *See infra* text accompanying note 80.

72. *See* Public Report, *supra* note 70.

73. Bruce Hoffman, *Terrorism Trends and Prospects*, *in* COUNTERING THE NEW TERRORISM 7, 11 n.10 (1999). For a more complete exposition of the definitional problems faced in developing the chronology, see Brian Michael Jenkins, *The Study of Terrorism: Definitional Problems* (Dec. 1980). A more complete exposition of the operational definition is as follows:

> We concluded that an act of terrorism was first of all a crime in the classic sense such as murder or kidnapping, albeit for political motives. Even if we accepted the assertion by many terrorist that they were waging war and were therefore soldiers—that is, privileged combatants in the strict legal sense—terrorist tactics, in most cases, violated the rules that governed armed conflict—for example, the deliberate targeting of noncombatants or actions against hostages. We recognized that terrorism contained a

Using this concept of "traditional terrorism," the model assumes differing levels of false positives for the three scenarios being analyzed. Because bombing is a common terrorist tactic that is not used very often for non-terrorist purposes,[74] the model assumes that there will be relatively few false positives will arise in the case of a bomb attack. The assumption is that terrorists are behind a bombing in four out of five cases, or 80% of the time, leaving false positives of 20%.

Chemical attacks are much less common than bombings,[75] but the escalation of lethality of terrorist acts, the availability of materials to develop a chemical attack, and the foiled plots of terrorist groups makes chemical attacks a serious threat.[76] This model, taking what might be a conservative view, will assume that two out of five chemical attacks (or 40%) are due to "traditional terrorism,"

> psychological component—it was aimed at the people watching. The identities of the actual targets or victims of the attack often were secondary or irrelevant to the terrorists' objective of spreading fear and alarm or gaining concessions. This separation between the actual victim of the violence and the target of the intended psychological effect was the hallmark of terrorism. It was by no means a perfect definition and it certainly did not end any debates, but it offered some useful distinctions between terrorism and ordinary crime, other forms of armed conflict, or the acts of psychotic individuals.

Brian Michael Jenkins, *Foreword* to COUNTERING THE NEW TERRORISM, at iii (1999).

> A "global" definition of terrorism for insurance purposes has been suggested as follows:
> An act, including, but not limited to, the use of force or violence, committed by any person or persons acting on behalf of or in connection with any organization creating serious violence against a person or serious damage to property or a serious risk to the health or safety of the public undertaken to influence a government for the purpose of advancing a political, religious or ideological cause.

Thomas A. Player et al., *A Global Definition of Terrorism*, Proceedings of the Asia Pacific Risk and Insurance Association Sixth Annual Conference (July 24-26, 2002) (on file with author). It should be noted that this definition tries to address some of the transaction costs by having a judicial or administrative official certify that an act is one of terrorism under the definition, and that this certification is not subject to appeal. *Id.*

74. For example, nine out of thirteen significant terrorist incidents used to illustrate the religious element to recent terrorism involved bombings. *See* Hoffman, *supra* note 73, at 17-19. The other four incidents were a nerve-gas attack, an assassination, "bloodletting by Islamic extremists . . . that has claimed the lives of more than an estimated 75,000 persons," and a "massacre . . . of foreign tourists" in Egypt. *Id.* If bombs were used in the last two incidents, which is certainly possible or even likely, then bombing was involved in eleven out of thirteen incidents.

75. The use of sarin nerve gas by Aum, an apocalyptic Japanese religious sect, in 1995 was the first use of a chemical warfare agent by a non-state entity against a civilian population. *See* BRUCE HOFFMAN, TERRORISM AND WEAPONS OF MASS DESTRUCTION, AN ANALYSIS OF TRENDS AND MOTIVATIONS 3 & n.1 (1999).

76. *See generally id.* For a couple of examples of foiled plots, see *id.* at 29-30. It is noteworthy that "[t]he position of most academic terrorism analysts has been far more restrained and skeptical than many of their counterparts in government, the military and law enforcement" about the likelihood of terrorist use of weapons of mass destruction. *Id.* at 58.

leaving a 60% rate of false positives.

Internet vandalism, while a subject of great interest and concern, is even less likely than a chemical attack to be the result of terrorism. Reports of computer hacking and viruses are quite common, but, while there is speculation that terrorists might be behind such incidents (as well as evidence of terrorist plots to disrupt the Internet), there are few, if any, cases of Internet vandalism connected to terrorism.[77] Those involved in "traditional terrorism" generally use violence or threat of violence to cause fear of personal injury, whereas Internet vandalism is mostly, if not entirely, limited to property damage. The model, again taking a somewhat conservative view, assumes that only one out of five Internet vandalism incidents (20%) are due to traditional terrorism, leaving a false positive rate of 80%.

6. *Summary Tables.*—The probabilities of false positives and of damages can be used to calculate average, weighted costs and damages for the different scenarios. The following tables summarize the assumptions and do the weighting calculations. Table 2 shows the three damage scenarios with their related damages and maximum and minimum transaction costs (depending on the elements at issue), all weighted by the probability that such a scenario will occur. The minimum and maximum transaction costs are based on the preceding assumptions. The maximum reaches the upper limits of the model's assumptions only in the case of a bombing or Internet vandalism at the medium level of damages because that is the only time that both elements are likely to be fully contested.

Table 2 – Damage Scenarios and Transaction Costs, Weighted by Probability

	Probability	Damages	Weighted Damages	Max TC	Weighted Max TC	Min TC	Weighted Min TC
High	.000001	$1 B	$1000	$100 M	$100	$100 M	$100
Med	.0001	$25 M	$2500	$5 M	$500	$2.5 M	$250
Low	.01	$1 M	$10,000	$100 K	$1,000	$0	$0

The next table, Table 3, carries over the weighted transaction costs from the three damages scenarios, puts them with the three action scenarios (bombing, chemical attack and Internet vandalism), and makes an allocation to account for

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77. *See* DOROTHY E. DENNING, *Activism Hacktivism and Cyberterrorism: The Internet as a Tool for Influencing Foreign Policy, in* NETWORKS AND NETWARS: THE FUTURE OF TERROR, CRIME, AND MILITANCY 239, 288 (John Arquilla & David Ronfeldt eds., 2001) ("With regard to cyberterrorism, that is the use of hacking tools and techniques to inflict grave harm such as loss of life, few conclusions can be drawn about its potential effect on foreign policy, because there have been no reported incidents that meet the criteria."); *see also* Simon Hayes, *Net Terror Fails To Live Up To Hype*, THE AUSTRALIAN, Sept. 10, 2002, at 30; Bill Wallace, *Security Analysts Dismiss Fears Of Terrorist Hackers; Electricity, Water Systems Hard to Damage Online*, S.F. CHRON., June 30, 2002, at A11. For a general description of the possible use of the Internet for terrorism, see Tom Regan, *When Terrorists Turn to the Internet*, CHRISTIAN SCI. MONITOR, July 1, 1999, at 17; *see also Get Ready for Cyber-terrorism*, THE DAILY TELEGRAPH, May 17, 2000, at 39.

false positives. It uses the minimum weighted transaction costs for the high damages scenario because the threshold element will not be at issue in that scenario.

Table 3 uses the maximum weighted transaction costs for the bombing and Internet attacks at a medium level of damages because both the intent and threshold are elements likely to be fully contested. It uses the minimum transaction costs for the chemical attack scenario at the medium level because only the intent element will be at issue.

For the low level of damages, Table 3 includes no transaction costs for bombing because the damages are so far below the threshold that the exclusion will not be litigated. It uses the maximum weighted transaction costs for the chemical attack because the threshold element does not apply, so a finding of terrorist intent would preclude coverage for the loss. It also uses the maximum weighted transaction costs for Internet vandalism because the nature of the Internet makes the aggregation of the claim possible. Although this is less likely than in the medium damage scenario, the minimum level of transaction costs is used because both the intent and threshold elements would be at issue and because the maximum at the low level of damages is only 10% (compared to 20% transition costs at the medium level).

In addition to separating out the different level of weighted transaction costs, Table 3 also allocates those costs based on the false positive ratio. It uses the ratio to track the proportion of the transaction costs that are likely to be "wasted" by being used on a false positive case, on what seems to be a terrorist incident within the definition of the exclusion, but which is not within the definition of "traditional terrorism" set forth above.

Here are the figures:

Table 3 – Action Scenarios and Weighted Transaction Costs, Allocated by False Positive Ratios

	False Pos. Ratio	TC High	Allocated	TC Med	Allocated	TC Low	Allocated
Bombing	80/20	$100	$80/20	$500	$400/100	$0	$0
Chemical	40/60	$100	$40/60	$250	$100/150	$1,000	$400/600
Internet	20/80	$100	$20/80	$500	$100/400	$1,000	$200/800

Table 4 takes the transaction costs figures for each action scenario, totals them for the three damage levels, and then applies the false positive ratio. The total transaction costs are then divided into two categories: "correct" and "false positive" cases. The "correct" category represents transaction costs used to obtain the application of the exclusion in cases in which the terrorism exclusion should be applied. The "false positive" category represents transaction costs that are wasted in the sense that they are expended on cases where the exclusion should not apply. The correct and false positive categories are then totaled.

Table 4 – Total Weighted Transaction Costs by Action Scenario, Allocated by False Positive Ratios

	TC High	TC Med	TC Low	Total TC	False Pos Ratio	Correct	False Positive
Bombing	$100	$500	$0	$600	80/20	$480	$120
Chemical	$100	$250	$1,000	$1350	40/60	$540	$810
Internet	$100	$500	$1,000	$1600	20/80	$320	$1280
Total	$300	$1250	$2,000	$3550		$1340	$2210

C. Analysis

1. Wasted Transaction Costs—Intent Element.—The model shows that, under the given assumptions, the transaction costs attributable to false positives ($2210) are significantly greater (by 60%) than those that can be allocated to correct cases ($1340). This shows that, on balance, more of the transaction costs will be wasted than will be used to achieve the desired result. This outcome is due to the relatively higher rates of false positives in the chemical and Internet scenarios combined with the higher probabilities associated with lower-damage cases where the false positives will have even more impact.

If we look at the Internet scenarios individually, the wasted transaction costs are an even greater proportion of the total costs. In that scenario, the wasted transaction costs are $1280 compared to only $320 in transaction costs for correct cases. Thus, wasted transaction costs are four times greater than the transaction costs for the correct cases.

2. Reallocation of Wasted Transaction Costs for the Threshold Element.—This allocation, however, needs to be adjusted to account for the uncertainty of outcomes for the threshold determination. The analysis and tables up to this point have focused on transaction costs associated with the terrorist intent element. Because the medium loss cases have damages at the threshold margin, the threshold element will generate additional wasted transaction costs for false positives cases.

If we assume that insurers will prevail on the threshold issue half the time, while policyholders would prevail the other half of the time, then half of the transaction costs originally allocated to the correct category need to be reallocated to the false positive category at the medium level of damages. Therefore, in the bombing scenario, where the allocation is $400 of transaction costs in the "correct" category and $100 in the "wasted" category,[78] $200 needs to be reallocated from correct to wasted. For the Internet scenario, the original allocation was $100 correct and $400 wasted,[79] so $50 needs to be reallocated. Because the threshold element does not apply to chemical attacks, transaction costs in that scenario do not need to be reallocated.

Transaction costs need to be reallocated at the low level of damages as well,

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78. *See supra* Table 3.

79. *See id.*

but to a lesser extent, and only for the Internet scenario. The threshold element does not apply to the low-damages bombing scenario because $1 million in damages is unlikely to be aggregated to reach the threshold. The nature of the Internet, however, allows viruses to multiply and an spread so quickly and easily that it may be possible to aggregate a $1 million claim with enough other claims to meet the threshold. The model assumes that the threshold element will be litigated only about half the time in the low-damage Internet scenario because the amount of the claim is so far below the threshold that, while aggregation is possible, it would not be an issue in every case.[80] Therefore, when calculating the reallocation of transaction costs for the low-damages Internet scenario, only one-quarter of the transaction costs in the correct category (one-half of the one-half attributable to the threshold element) needs to be reallocated. The original allocation for the low-damage Internet scenario was $200 correct and $800 wasted,[81] so $50 needs to be reallocated (one-quarter of the correct amount). When the $50 for the low-damage Internet scenario is combined with the $50 from the medium-damage scenario, the total reallocation for the Internet scenario is $100.

Table 5 shows the weighted transaction costs for the bombing and Internet scenarios at the medium and low levels of damages, the allocation between correct and wasted transaction costs, and the reallocation to account for the average outcomes regarding the threshold issue. (The chemical scenario and the high damage levels require no reallocation because the threshold issue is not involved for those scenarios.)

Table 5 – Reallocation of Correct Costs by Damages and Action Scenario

	TC Medium	Allocated	TC Low	Allocated C	Total Allocated	Reallocation
Bombing	$500	$400/100	$0	$0	$400/100	$200
Internet	$500	$100/400	$1,000	$200/800	$300/1200	$100
Total	$1000	$500/500	$1,000	$200/800	$700/1300	$300

The total transaction costs to be reallocated is $300 ($200 for the bombing scenario and $100 for Internet). When this amount is moved from the "correct" category to the "wasted" category, the total wasted increases from $2210 to $2510, while the total in the correct category drops from $1340 to only $1040.[82] As a result of this adjustment, the wasted transaction costs are now more than twice the transaction costs used to obtain the correct application of the exclusion. Table 6 shows the reallocation in the context of the other transaction costs separated by scenario.

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80. *See supra* Part III.B.4.
81. *See supra* Table 3.
82. *See supra* Table 4.

Table 6 – Reallocation of Transaction Costs to Account for Threshold False Positives

	Correct Intent	False Pos. Intent	Reallocation	Correct Intent & Threshold	False Positives Intent & Threshold
Bombing	$480	$120	$200	$280	$320
Chemical	$540	$810	$0	$540	$810
Internet	$320	$1280	$100	$220	$1380
Total	$1340	$2210	$300	$1040	$2510

Table 6 also shows how the correct use of transaction costs is even further eroded once the false positives are considered for both the intent and threshold elements of the exclusion. Even in the case of a bombing, where the probability is quite high for proof of terrorist intent, once the uncertainty of the threshold factor is considered, the transaction costs allocated to the false positives are greater than those allocated to the correct application of the exclusion. That difference is magnified, of course, in the Internet case where we have much less confidence that the exclusion will be attributed to terrorist activity. In the case of Internet vandalism, the false positive transaction costs of $1380 are more than six times as much as the correct transaction costs of $220.

Once the transaction costs for false positives are combined with the transaction costs for correct cases, the total transaction costs are high as a proportion of the total value of the claims. The total weighted value of the transaction costs for the Internet scenario, for instance, are nearly 60% of the total weighted average claim for a terrorist attack.[83] Even the bombing scenario, which has the lowest false positive rate, has total weighted transaction costs of about 50% at the medium level of damages because of the threshold element.[84]

3. Effect of Wasted Transaction Costs.—The range of 50-60% for transaction costs compared to damages figures, though high, does not in itself undermine the justification for the use of the terrorism exclusion.[85] After all,

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83. This is how I arrive at the ratio. The total average, weighted claims for the Internet scenario is $13,500 ($1000 for high damages, $2500 for medium damages, and $10,000 for low damages). The false positive rate, however, is 80%, so the value of an average, probability-weighted Internet terrorist attack is $2700 ($13,500 x .2). Compare this to total transaction costs of $1600 ($220 + $1380). *See* Table 6. Transaction costs of $1600 are 59.26% of $2700.

84. This is how I arrive at the ratio. The false positive rate is only 20% for bombings, but at the medium level of damages only half of the correct cases will meet the threshold. Thus, at the medium level of damages the total average damages will only be $1000 (total average weighted damages of $2500, *see* Table 2, x .8 x .5). The average weighted transaction costs for correct bombing cases at the medium level is $200 plus $300 for incorrect cases, for a combined total of $500. *See* Table 5. The total transaction costs are 50% of the total average weighted damages of $1000 (500/1000).

85. Payments for transaction costs in asbestos cases reach 63% of total costs, and even in auto cases, which tend to be less complicated and expensive, transaction costs account for as much as

even if an insurer expends 60% in transaction costs, that still leaves a net savings of 40%. Therefore, even though not as efficient as it might be, the use of the exclusion appears to be rational.

What makes the use of the exclusion questionable, however, is the ratio of false positive transaction costs compared to correct transaction costs when considered in light of the collection of premium dollars. Because terrorism is excluded from coverage, insurers should not be able to charge a premium for that coverage. Insurers cannot not recoup the transaction costs by charging a higher premium for terrorist risks because such risks are not covered. They will, of course, include the transaction costs in their general expenses, which will affect the overall premium rate being charged to policyholders. In light of the ratios developed in this Article, it may be better as a matter of public policy for insurers to charge a higher premium to cover the terrorist risks and thereby avoid the wasted transaction costs. Depending on how much higher that cost would be, policyholders may well prefer that approach.

One final point is that the foregoing analysis has assumed that the courts will apply the terrorist exclusion only when terrorist intent is proven consistent with "traditional terrorism," which is more narrow than the definition of terrorism used in the exclusion.[86] That assumption could be incorrect. The courts might apply the terrorist intent element literally, which would mean that what has been characterized as false positive transaction costs would be reallocated to the "correct" category. In my view, this would not make the courts' determination "correct," but instead would move the false positives from the transaction costs to the substantive determination of the applicability of the exclusion. In other words, while the transaction costs would not be "wasted" in the sense that they were expended without the application of the exclusion, the determination that the exclusion would apply would be a false positive in the chemical and Internet cases using the preceding ratios. The literal application of the exclusion's definition of terrorist intent would therefore exacerbate the false positives problem, rather than eliminate it.

CONCLUSIONS AND IMPLICATIONS

A. Efficiency

This analysis has shown that the terrorist exclusions will incur significant transaction costs, the majority of which are likely to be wasted in the sense that they are incurred in cases where the exclusion does not or should not apply. In some scenarios, the proportion of "wasted" transaction costs is as much as six times the transaction costs that are incurred for cases where the exclusion will apply.[87] The high ratio of wasted transaction costs is a function of the

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43% of total costs. *See* HENSLER ET AL., TRENDS IN TORT LITIGATION: THE STORY BEHIND THE STATISTICS 27-28 (1987).

86. *See supra* text accompanying notes 70-73.

87. *See supra* Table 6 and accompanying text.

combination of the following: the breadth of the exclusion, the rate of false positives, the probabilities of damage levels (in particular those below the threshold), and uncertainty in the threshold requirement. At a minimum, this analysis shows inefficiency caused by the exclusion.

This analysis also suggests some possible ways that efficiency might be improved. In particular, focusing the exclusion on the bombing scenario would increase efficiency because it has the lowest transaction costs, in large part because it has the lowest chance of false positives. In other words, one way to increase efficiency would be to make the exclusion inapplicable to the kind of incidents that are likely to be high in false positive, such as chemical releases and Internet vandalism.

This analysis also shows inefficiency generated by the threshold element for cases at the threshold margin. The threshold element increases transaction costs because it is very difficult to measure and aggregate damages. Because meeting the threshold is essential to the application of the exclusion, parties have a strong incentive to incur these costs in marginal cases. This incentive, however, works in the opposite direction of the incentives in typical insurance coverage disputes. The threshold encourages insurers to find more damages than are claimed, while policyholders are encouraged to underreport damages to avoid the threshold. The uncertainty of calculating and aggregating damages causes the cases at the threshold margin to split between coverage and exclusion fairly randomly, which means that these transaction costs are likely to be wasted in at least half of these cases, even for those scenarios such as bombing that have low false positives. Thus, in the medium-damages bombing scenario, the average weighted transaction costs are $200 for cases where the exclusion is applied and $300 for cases where the exclusion does not apply.[88] As a result, once the wasted transaction costs are added to the other transaction costs, the total transaction costs are 50% of the total average weighted damages that would be avoided by the application of the exclusion.[89]

These high transaction costs suggest that alternatives to the threshold element should be considered. One possibility would be an exclusion without a threshold, which is the approach taken for nuclear, chemical and biological attacks. This may not be politically feasible, but the model shows that this approach would save transaction costs. Alternatively, some of the transaction costs problems could be avoided if the threshold element were treated as a limit on damages rather than a trigger for an exclusion. This would avoid the perverse incentive problem and would avoid the random application of the exclusion to marginal cases. However, it would also limit the ability of the exclusion to prevent insolvency, though perhaps the insolvency could be addressed by using a lower threshold.

The model raises questions about the overall efficiency of the exclusion. Although high transaction costs alone do not demonstrate inefficiency, because one must consider whether there are more efficient alternatives, it suggests that

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88. *See supra* Table 5.

89. *See supra* note 84 and accompanying text.

an efficiency analysis should be undertaken. This model did not analyze overall efficiency because it did not consider the benefits that are incurred by the exclusion. Although the transaction costs are less than 100% of the benefits, thereby leaving some net benefit, this may not be sufficient to justify the high transaction costs once the ability to collect a premium is considered. If terrorist-related losses were covered, the transaction costs would be avoided and insurers would be entitled to an additional premium for that coverage. Overall, this may be a more efficient option than trying to exclude terrorist losses, which may not be effective, will incur high transaction costs, and will leave policyholders bearing the risk. While insurers are understandably nervous about the risks posed by such coverage after the September 11 attack, they are still in a better position to evaluate and pool the risks than are policyholders. Moreover, under the present exclusion, insurers cannot be completely confident that the exclusion will be applied except in the most obvious and catastrophic cases, which are the least likely to occur.

B. Implications

The efficiency conclusions lead to some interesting policy implications for the industry, regulators, and Congress. The combination of high transaction costs and absence of premium may undermine the benefits of the terrorism exclusion, in which case insurers would be better off not using it. Perhaps the market is already moving in this direction. The insurance market is starting to offer some terrorism coverage.[90] Nevertheless, most insurers seem to be opting for the exclusion rather than the premium that would come from offering the coverage,[91] which raises the question of whether, or to what extent, transaction costs have been considered.

Regulators have approved the terrorism exclusion, and, like the industry, may not have considered the transaction costs. If they had, they might have opted for a narrower exclusion. The fact that the threshold element, which is one of the most troublesome parts of the terrorism exclusion, was adopted in response to regulatory pressure suggests that transaction costs were not part of the calculus. This analysis suggests that it should be, and that in considering the transaction costs the regulators can encourage or require a more efficient exclusion.

Finally, one of the potential benefits of congressional action on terrorism insurance is the limiting of these transaction costs. The Terrorism Risk Insurance Act includes measures to reduce transition costs. The Secretary of the Treasury, for example, is empowered by the Act to "certify" an act as an "act of terrorism,"

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90. *See, e.g.*, *Terror Coverage Market Grows*, BUS. INS., Feb 18, 2002; *U.S. Terror Pool: Whose Terror Is It?*, REACTIONS, Feb. 2002, at 38-41.

91. *See, e.g.*, David Hale, *America Uncovered: Congress's Failure to End the Deadlock in Terrorism Insurance Could Cost the Country Dear*, FIN. TIMES, Sept. 12, 2002, at 11; Jackie Spinner, *Terrorism Insurance Still Rare*, WASH. POST, Sept. 11, 2002, at E03; *see also supra* note 29; Hillman testimony, *supra* note 2, at 3-6.

and that certification is final and not subject to judicial review.[92] This will avoid substantial transaction costs associated with the terrorism intent element of the exclusion for those losses covered by the Act.[93]

92. *See* Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, § 102(1), 116 Stat. 2322 (2002).

93. *See supra* notes 34-38 and accompanying text.

APPENDIX A

IL 09 38 01 02

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

EXCLUSION OF WAR, MILITARY ACTION AND TERRORISM

This endorsement modifies insurance provided under the following:

BOILER AND MACHINERY COVERAGE PART
COMMERCIAL CRIME COVERAGE FORM
COMMERCIAL CRIME POLICY
COMMERCIAL INLAND MARINE COVERAGE PART
COMMERCIAL PROPERTY COVERAGE PART
FARM COVERAGE PART
GOVERNMENT CRIME COVERAGE FORM
GOVERNMENT CRIME POLICY
STANDARD PROPERTY POLICY

A. The War And Military Action Exclusion is replaced by the following Exclusion. With respect to any Coverage Form to which the War And Military Action Exclusion does not apply, that Exclusion is hereby added as follows.

WAR AND MILITARY ACTION EXCLUSION

We will not pay for loss or damage caused directly or indirectly by the following. Such loss or damage is excluded regardless of any other cause or event that contributes concurrently or in any sequence to the loss.

1. War, including undeclared or civil war;
2. Warlike action by a military force, including action in hindering or defending against an actual or expected attack, by any government, sovereign or other authority using military personnel or other agents; or
3. Insurrection, rebellion, revolution, usurped power or action taken by governmental authority in hindering or defending against any of these.

With respect to any action that comes within the terms of this exclusion and involves nuclear reaction or radiation, or radioactive contamination, this War And Military Action Exclusion supersedes the Nuclear Hazard Exclusion.

B. Regardless of the amount of damage and losses, the Terrorism Exclusion applies to any incident of terrorism that involves the use, release or escape of pathogenic or poisonous biological or chemical materials or of nuclear materials, or to any incident that directly or indirectly results in nuclear reaction or radiation or radioactive contamination.

In incidents of terrorism other than those described in the preceding sentence, the Terrorism Exclusion will not apply unless the damage to all types of property (in the United States, its territories and possessions, Puerto Rico and Canada), sustained by all persons and entities affected by the terrorism (and including business interruption losses sustained by owners or occupants of such damaged property), all whether or not insured, exceeds a total of $25,000,000, attributable to a single incident of terrorism or to multiple incidents which occur within a 72-hour period and appear to be carried out in concert or to have a related purpose or common leadership.

TERRORISM EXCLUSION

We will not pay for loss or damage caused directly or indirectly by terrorism, including action in hindering or defending against an actual or expected incident of terrorism. Such loss or damage is excluded regardless of any other cause or event that contributes concurrently or in any sequence to the loss.

Terrorism means activities against persons, organizations or property of any nature:

1. That involve the following or preparation for the following:
   a. Use or threat of force or violence;
   b. Commission or threat of a dangerous act; or
   c. Commission or threat of an act that interferes with or disrupts an electronic, communication, information or mechanical system; and

2. When one or both of the following applies:
   a. The effect is to intimidate or coerce a government or the civilian population or any segment thereof, or to disrupt any segment of the economy; or
   b. It appears that the intent is to intimidate or coerce a government, or to further political, ideological, religious, social or economic objectives or to express (or express opposition to) a philosophy or ideology.

But with respect to any such activity that also comes within the terms of the War And Military Action Exclusion, that exclusion supersedes this Terrorism Exclusion.

In the event of an act of terrorism that involves nuclear reaction or radiation, or radioactive contamination, this Terrorism Exclusion supersedes the Nuclear Hazard Exclusion.

APPENDIX B

COMMERCIAL GENERAL LIABILITY
CG 21 69 01 02

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

WAR OR TERRORISM EXCLUSION

This endorsement modifies insurance provided under the following:

COMMERCIAL GENERAL LIABILITY COVERAGE PART

A. Exclusion **i.** under Paragraph **2., Exclusions** of **Section I – Coverage A – Bodily Injury And Property Damage Liability** is replaced by the following:

2. Exclusions

This insurance does not apply to:

i. War Or Terrorism

"Bodily injury" or "property damage" arising, directly or indirectly, out of:

(1) War, including undeclared or civil war; or

(2) Warlike action by a military force, including action in hindering or defending against an actual or expected attack, by any government, sovereign or other authority using military personnel or other agents; or

(3) Insurrection, rebellion, revolution, usurped power, or action taken by governmental authority in hindering or defending against any of these; or

(4) "Terrorism", including any action taken in hindering or defending against an actual or expected incident of "terrorism"

regardless of any other cause or event that contributes concurrently or in any sequence to the injury or damage.

However, with respect to "terrorism", this exclusion only applies if one or more of the following are attributable to an incident of "terrorism":

(1) The total of insured damage to all types of property exceeds $25,000,000. In determining whether the $25,000,000 threshold is exceeded, we will include all insured damage sustained by property of all persons and entities affected by the "terrorism" and business interruption losses sustained by owners or occupants of the damaged property. For the purpose of this provision, insured damage means damage that is covered by any insurance plus damage that would be covered by any insurance but for the application of any terrorism exclusions ; or

(2) Fifty or more persons sustain death or serious physical injury. For the purposes of this provision, serious physical injury means:

(a) Physical injury that involves a substantial risk of death; or

(b) Protracted and obvious physical disfigurement; or

(c) Protracted loss of or impairment of the function of a bodily member or organ; or

(3) The "terrorism" involves the use, release or escape of nuclear materials, or directly or indirectly results in nuclear reaction or radiation or radioactive contamination; or

(4) The "terrorism" is carried out by means of the dispersal or application of pathogenic or poisonous biological or chemical materials; or

(5) Pathogenic or poisonous biological or chemical materials are released, and it appears that one purpose of the "terrorism" was to release such materials.

Paragraphs **(1)** and **(2)**, immediately preceding, describe the thresholds used to measure the magnitude of an incident of "terrorism" and the circumstances in which the threshold will apply for the purpose of determining whether the Terrorism Exclusion will apply to that incident. When the Terrorism Exclusion applies to an incident of "terrorism", there is no coverage under this Coverage Part.

In the event of any incident of "terrorism" that is not subject to the Terrorism Exclusion, coverage does not apply to any loss or damage that is otherwise excluded under this Coverage Part.

Multiple incidents of "terrorism" which occur within a seventy-two hour period and appear to be carried out in concert or to have a related purpose or common leadership shall be considered to be one incident.

B. The following exclusion is added to Paragraph **2., Exclusions** of **Section I – Coverage B – Personal And Advertising Injury Liability:**

2. Exclusions

This insurance does not apply to:

War Or Terrorism

"Personal and advertising injury" arising, directly or indirectly, out of:

(1) War, including undeclared or civil war; or

(2) Warlike action by a military force, including action in hindering or defending against an actual or expected attack, by any government, sovereign or other authority using military personnel or other agents; or

(3) Insurrection, rebellion, revolution, usurped power, or action taken by governmental authority in hindering or defending against any of these; or

(4) "Terrorism", including any action taken in hindering or defending against an actual or expected incident of "terrorism"

regardless of any other cause or event that contributes concurrently or in any sequence to the injury.

However, with respect to "terrorism", this exclusion only applies if one or more of the following are attributable to an incident of "terrorism":

(1) The total of insured damage to all types of property exceeds $25,000,000. In determining whether the $25,000,000 threshold is exceeded, we will include all insured damage sustained by property of all persons and entities affected by the "terrorism" and business interruption losses sustained by owners or occupants of the damaged property. For the purpose of this provision, insured damage means damage that is covered by any insurance plus damage that would be covered by any insurance but for the application of any terrorism exclusions ; or

(2) Fifty or more persons sustain death or serious physical injury. For the purposes of this provision, serious physical injury means:

(a) Physical injury that involves a substantial risk of death; or

(b) Protracted and obvious physical disfigurement; or

(c) Protracted loss of or impairment of the function of a bodily member or organ; or

(3) The "terrorism" involves the use, release or escape of nuclear materials, or directly or indirectly results in nuclear reaction or radiation or radioactive contamination; or

(4) The "terrorism" is carried out by means of the dispersal or application of pathogenic or poisonous biological or chemical materials; or

(5) Pathogenic or poisonous biological or chemical materials are released, and it appears that one purpose of the "terrorism" was to release such materials.

Paragraphs **(1)** and **(2)**, immediately preceding, describe the thresholds used to measure the magnitude of an incident of "terrorism" and the circumstances in which the threshold will apply for the purpose of determining whether the Terrorism Exclusion will apply to that incident. When the Terrorism Exclusion applies to an incident of "terrorism", there is no coverage under this Coverage Part.

In the event of any incident of "terrorism" that is not subject to the Terrorism Exclusion, coverage does not apply to any loss or damage that is otherwise excluded under this Coverage Part.

Multiple incidents of "terrorism" which occur within a seventy-two hour period and appear to be carried out in concert or to have a related purpose or common leadership shall be considered to be one incident.

C. Exclusion **h.** under Paragraph **2., Exclusions** of **Section I – Coverage C – Medical Payments** does not apply.

D. The following definition is added to the **Definitions** Section:

"Terrorism" means activities against persons, organizations or property of any nature:

1. That involve the following or preparation for the following:

a. Use or threat of force or violence; or

b. Commission or threat of a dangerous act; or

c. Commission or threat of an act that interferes with or disrupts an electronic, communication, information, or mechanical system; and

2. When one or both of the following applies:

a. The effect is to intimidate or coerce a government or the civilian population or any segment thereof, or to disrupt any segment of the economy; or

b. It appears that the intent is to intimidate or coerce a government, or to further political, ideological, religious, social or economic objectives or to express (or express opposition to) a philosophy or ideology.

INCOME TAX AS IMPLICIT INSURANCE AGAINST LOSSES FROM TERRORISM

TERRENCE CHORVAT*
ELIZABETH CHORVAT**

ABSTRACT

This Article examines the effects of the income tax rules as they relate to losses from terrorist attacks. It shows that the income tax system affords victims of terrorism a form of implicit insurance because the amount of tax owed decreases proportionately with the amount of the loss. The Article argues that the level of insurance should be greater for victims of terrorism than that provided to those who suffer other kinds of losses. Granting special tax benefits to victims of terrorist attacks provides behavioral incentives, not only for individuals and businesses who have suffered or might potentially suffer losses from terrorist attacks, but also for the government. The Article argues that, while the Victims of Terrorism Tax Relief Act of 2001 grants special tax benefits to victims of terrorism, this type of relief should be codified and should apply to all victims of terrorism against the United States, rather than granted on an *ad hoc* basis. Further, additional rules should be adopted which grant tax benefits to companies which provide insurance against terrorist attacks and favorable tax treatment should be given to expenses for the private provision of security against such attacks.

INTRODUCTION

This Article examines the public policy behind providing special tax benefits to the victims of terrorism. The total losses from the September 11, 2001 attacks are estimated to exceed $50 billion dollars and over 3000 lives.[1] Therefore, how these losses are treated for tax purposes is a significant issue. This Article analyzes how the tax system currently treats these losses and how these rules can be improved.

This Article will discuss how the income tax system provides a certain level of implicit insurance, which emanates from provisions that allow for deduction of losses and, in some instances, deduction of insurance payments, as well as the

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* Associate Professor of Law, George Mason University School of Law. J.D., 1989, University of Chicago; LL.M. (Taxation), 1991, New York University.

** Visiting Professor of Law, George Mason University School of Law. J.D., 1991, Wake Forest University; LL.M. (Taxation), 1997, University of Washington.

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1. Gordon Woo, Quantifying Insurance Terrorism Risk (Feb. 1, 2002) (unpublished paper, presented at the 2002 National Bureau of Economic Research Insurance Project Workshop), *available at* http://www.nber.org/~confer/2002/insw02/woo.pdf (last visited Oct. 15, 2002).

exclusion of recoveries from insurance companies or the tortfeasors themselves. It is estimated that the level of insurance provided by the tax system is of approximately the same level as automobile insurance, or health insurance.[2]

Because the tax system provides insurance against all losses, there is, inherent in the income tax system, a level of insurance against terrorist strikes. The tax rules should provide benefits to victims of terrorist attacks; therefore, in essence, the government is providing an additional layer of insurance against such attacks. Such additional insurance would have beneficial social consequences, in part because the government should insure against its own failures, and in part because the benefits can have favorable behavioral incentives.

The Article also argues that because governmental actors behave so as to maximize their own self-interest and consequently do not always act to maximize the total welfare of the citizens, if the government does not face an appropriately high cost, the government might insufficiently provide for defense against terrorism. By forcing the government to provide insurance for its failures, the tax system can overcome potential public choice problems that may result.

The Article argues that without additional behavioral incentives, individuals will not behave in a socially optimal way with respect to protection from terrorist acts. Because individual actors do not reap all of the benefits of the protection they provide, they might not take the appropriate level of protection against terrorist attacks. The argument is not that the people will take no action, but that they might not take optimal action. Because often the benefits of individual actions, such as those airlines may take against terrorists, can have external benefits to other actors, it very possible such activities would be under provided without governmental intervention.[3] This argument is based on a traditional rationale for governmental action: mitigating externalities some actors impose upon others.

The Article is divided into three parts. Part I analyzes the theory behind the income tax as well as the various specific rules that apply to losses from terrorist attacks. Part II analyzes the effect of tax rules on insurance companies and how they respond to catastrophic losses. It also discusses how allowing special tax benefits to particular victims of terrorism creates incentives to non-governmental actors that will optimize societal levels of insurance and security. Part III proposes specific changes to the current rules to influence governmental behavior. It discusses how addressing terrorism systematically, rather than through piecemeal legislation as is currently done, will improve the process by which budgetary decisions are made. It also discusses how allowing certain tax benefits to victims of terrorism can foster governmental action for socially productive behavior. It argues that, by encouraging the government to take on more of these losses and allocate more resources to security, giving benefits to

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2. Thomas P. Kniesner & James J. Ziliak, *Explicit Versus Implicit Income Insurance*, 25 J. RISK & UNCERTAINTY 5 (2002).

3. HOWARD KUNREUTHER & GEOFFREY HEAL, INTERDEPENDENT SECURITY: THE CASE OF IDENTICAL AGENTS (Nat'l Bureau of Econ. Research, Working Paper No. 8871, 2002).

victims of terrorism will improve governmental action because government decision-makers will be comparing the costs of defense against an amount which more closely represents the societal costs of terrorism rather than, as is the current practice, evaluating the costs of defense equipped only with an abstract notion of the costs of terrorism.

For purposes of this Article, the term "victim of terrorism" will include any person[4] who suffers loss (either physical or economic) from terrorist attacks designed to influence the U.S. government. The current tax provisions only address those who died or will die from injuries sustained from these attacks. The definition of "terrorism" used in this Article is similar to that used by the United Kingdom in connection with Pool RE,[5] the reinsurance pool for terrorist attacks against the United Kingdom.[6] As used here, the term would include the conduct of terrorist acts by such groups as Al Qaeda or the FMLN (the Puerto Rican independence group).

I. INCOME TAX RULES AND BEHAVIORAL INCENTIVES FOR TAXPAYERS

Before analyzing the effects of taxation on compensation for terrorism, it is necessary first to discuss the tax rules that apply to victims of terrorism. There are very few rules that apply solely to victims of terrorism, and these are discussed below in Part I.B.5. The majority of the tax rules applicable to losses from terrorist attacks relate generically to all who suffer loss. This section, therefore, will first discuss the fundamentals of the income tax system. It will begin by examining the basic definition of income for tax purposes. Then, it will examine the application of this definition to specific circumstances relevant to losses from terrorism. It will also examine the tax rules concerning losses to personal property, losses from medical expenses, and recoveries in tort. The section concludes by analyzing the rules that are specific to losses from terrorist acts.

A. The Definition of Income and the Theoretical Basis of the Income Tax

The income tax is designed to raise revenue for the government and allocate the tax burden based on the income of the citizens and residents of the United States. Income, for purposes of the income tax, is determined by the ability of the individual to "exercise control over the use of society's scarce resources."[7]

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4. For purposes of this Article, the term "person" means any legal person (e.g., individual, corporation, etc.).

5. *Terrorism Insurance: Alternative Programs for Protecting Insurance Consumers: Hearing on the Treasury Dep't Before the Senate Comm. on Banking, Hous., & Urban Affairs*, 108th Cong. 8-10 (2002) (prepared statement of Thomas J. McCool, General Accounting Office).

6. Dwight Jaffee & Thomas Russell, Extreme Events and the Market for Terrorist Insurance (Feb. 1, 2002) (unpublished paper, presented at the 2002 National Bureau of Economic Research Insurance Project Workshop), *available at* http://www.nber.org/~conf/2002/insw02/jaffee.pdf (last visited Oct. 20, 2002).

7. HENRY CALVERT SIMONS, PERSONAL INCOME TAXATION 49 (1936).

This is generally said to be equivalent to the net change in wealth plus amounts expended in personal consumption.[8] This is referred to as the Haig-Simons definition of income, after the two men who first proposed it.[9]

The definition of income in the Internal Revenue Code is essentially equivalent to the Haig-Simons definition. However, in determining the amount of taxable income, the U.S. tax law begins by including all receipts of money or property and then subtracting any costs of acquiring the income.[10] In addition, income tax rules exclude certain receipts that can essentially only be used for the production of income and cannot be used for consumption activities by the taxpayer.[11] At a very abstract level, the amount of income as determined under the Haig-Simons definition and the amount of income as determined under the Internal Revenue Code should be equal. If one subtracts those amounts which are neither saved nor used for personal consumption from the receipts of money or property, the resulting amount must be equal to savings plus consumption. The largest difference between the definition in the Internal Revenue Code and the Haig-Simons definition is attributable to the "realization" doctrine.[12] While there are many exceptions,[13] under the U.S. income tax, changes in wealth are not "realized" (i.e., included in the calculation of income for tax purposes) until the investment is sold or otherwise ended or terminated.[14] Under the Haig-Simons definition, a change to wealth that does not create current revenue would still be income subject to tax.[15] This is largely a timing distinction and, while timing differences can be quite significant, this difference will not be stressed in this Article.[16]

It is generally argued that an income tax is the best way to raise revenue because it reflects the individual's ability to pay[17] and is consequently a "fair" tax. Furthermore, it is argued that the income tax interferes less with economic

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8. Because the income is a flow amount rather than a stock amount, it must be calculated based on an accounting period, which, in the case of income, is on an annual basis.

9. ROBERT MURRAY HAIG ET AL., THE FEDERAL INCOME TAX (series of lectures delivered at Columbia University in December 1920) (Robert Murray Haig ed., 1921); *see also* SIMONS, *supra* note 7.

10. I.R.C. §§ 61-63 (2000). It also allows certain other deductions for other purposes. *See* discussion *infra* Part II.A.

11. David M. Schizer, *Realization as Subsidy*, 73 N.Y.U. L. REV. 1549 (1998).

12. *Id.*

13. There are many exceptions to this rule, including non-recognition provisions such as I.R.C. section 1031 and sections 351-368, as well as placing securities dealers on a mark to market system (I.R.C. section 475).

14. I.R.C. § 1001 (2000).

15. SIMONS, *supra* note 7.

16. For examples of methods the tax system could use to eliminate the timing differences, see David Bradford, *Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Finance Instruments*, 40 TAX L. REV. 731 (1995).

17. STEPHEN G. UTZ, TAX POLICY: AN INTRODUCTION AND SURVEY OF THE PRINCIPLE DEBATE (1993).

decisions than do other taxes because all income, irrespective of source, is taxed.[18] These conclusions are generally derived from a utilitarian framework.[19] This Article does not attempt to question any of these presumptions and will generally assume that they are correct.[20]

B. Insurance Aspects of the Income Tax

The income tax not only raises revenue but also provides a form of insurance for taxpayers. This insurance results from the allowance of a deduction for losses. The deduction causes the actual out-of-pocket cost associated with losses to become $(1 - t) L$, where t is the tax rate and L is the amount of the loss.[21] If the tax rate is greater than zero, after-tax losses will be less than the original loss. As long as the tax rate is less than 100%, some of the loss remains with the taxpayer. Thus, the income tax deduction serves only as partial insurance[22] because, under current rates of tax, most of the loss remains with the taxpayer.[23] Even so, this insurance aspect of the income tax has very large effects on the utility of taxpayers. Kniesner and Ziliak estimate that its effect on utility is

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18. I.R.C. § 61 (2000). Interference with economic decisions is generally viewed as decreasing the efficiency of the economy. If all types of income are taxed at the same rate, decisions between whether to earn income from one activity or another should not be affected by the income tax. *See* Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 ARIZ. L. REV. 835 (2000). But see discussion *infra* Part I.C for analysis of Pigouvian taxes (discussing the issue of the allocation between income and consumption that is created by the income tax).

19. *See* Thomas D. Griffith, *Should "Tax Norms" Be Abandoned? Rethinking Tax Policy Analysis and the Taxation of Personal Injury Recoveries*, 1993 WIS. L. REV. 1115 (analyzing pain and suffering damages under an *ex ante* Pareto superiority norm yields different conclusions than under traditional tax norms like horizontal equity and the ideal tax base, norms which should be abandoned because they are not grounded in general ethical theory); *see also* Louis Kaplow, *The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums*, 79 CAL. L. REV. 1485 (1991).

20. For works which attempt to do this, see Edward McCaffrey, *Cognitive Theory and Tax*, *in* BEHAVIORAL LAW AND ECONOMICS 398 (Cass R. Sunstein ed., 2000).

21. For an analysis of the potential "double recovery" for victims of crime, see *People v. Sullivan*, 71 Cal. Rptr. 2d 440 (Ct. App.), *appeal granted and opinion superseded*, 955 P.2d 448 (Cal. 1998) (explaining that statute which required criminal convicts to pay restitution, convicts could not deduct payments from victim's insurer); Eric Kades, *Windfalls*, 108 YALE L.J. 1489 (1999).

22. *See* Robert A. Baruch Bush, *Between Two Worlds: The Shift From Individual to Group Responsibility in the Law of Causation of Injury*, 33 UCLA L. REV. 1473 (1986); *see* Griffith, *supra* note 19.

23. The highest marginal rate is 38.6%, which is scheduled to decline to 35%. I.R.C. § 1(a)(i) (2000). Therefore 61.4% of the risk remains with the taxpayer. This calculation ignores state taxation which reduces the risk retained by the individual even further.

approximately the same size as automobile insurance or health insurance.[24]

This section will explore how the income tax rules provide insurance to taxpayers in specific situations. It will discuss how this insurance is provided as well as the limitations on this insurance.

1. Losses of Business and Investment Property.—Losses of business property are generally deductible when the property is damaged.[25] Under the Haig-Simons definition of income, the amount of loss in the value of property held for use, either in a trade or business or as an investment, is the associated reduction in income of the taxpayers. For example, assume A has a business and the total assets of the business are worth $100,000 at the beginning of the year, including a $10,000 computer. If the computer is destroyed and has to be replaced,[26] A has suffered a $10,000 loss and the net value of assets of the business is now $90,000. Because there has been a net decrease to wealth, A's taxable income is reduced by $10,000.[27] Hence, the amount of income tax A owes will be reduced by $10,000 multiplied by the tax rate.

An alternative way of addressing potential loss is for the owner to take out an insurance policy against the loss. This transfers the risk of loss to an insurance company, which presumably will not be as risk averse as the taxpayer.[28] If the insurance policy is actuarially fair, the cost of the policy will be equal to the risk of loss multiplied by the potential loss.[29] Hence, the premiums are simply the expected value of the loss. In order to not distort the taxpayer's decision of whether to purchase an insurance policy or to self-insure, the tax system should allow the insurance premiums to be deducted in the same manner as would be the loss.[30] Furthermore, any recovery made under the insurance policy should not be included in income. Unless the amount of insurance over-compensates the insured for the amount of loss, recovery under the insurance policy merely returns the insured to the same economic position that existed prior to the loss. To illustrate this, in the previous example, if the risk of loss was 2%, the actuarially fair premium would be $200.[31] If A took out such a policy and suffered a $10,000 loss, he would receive a $10,000 insurance payment. There would have been no net change in wealth. However, payment of the insurance premium is equivalent to a loss and should therefore be

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24. Kniesner & Ziliak, *supra* note 2.

25. I.R.C. § 165(c) (2000).

26. This example assumes the computer is not insured.

27. I.R.C. §§ 162, 165 (2000).

28. WALTER NICHOLSON, MICROECONOMIC THEORY (1998). This results from the diversification of the risk. George Priest, *Rethinking the New Deal and the Liberal State: The Role of Government as Insurer* (Nov. 8, 2001) (unpublished working paper), *available at* http://lawschool.stanford.edu/olin/papers/GeorgePriestSpring2002.pdf; *see also* Terrence R. Chorvat, *Ambiguity and Income Taxation*, 23 CARDOZO L. REV. 617 (2002).

29. NICHOLSON, *supra* note 28.

30. If such losses were not deductible, then the tax system would encourage the losses to be self-insured. *See* discussion *infra* Part I.C.

31. This is 2% of $10,000.

deductible.[32]

Allowing deductions for insurance premiums permits taxpayers to arrange their affairs so as to increase the expected value of the risks and rewards. The tax system neither encourages nor discourages insuring against these losses. In the example above, if the taxpayer self-insured, the expected value of the deduction would be $200 and the insurance premium would also create a $200 deduction.

2. Losses of Personal Property.—The analysis of the treatment of losses on property used for consumption purposes is more difficult than for property used for the production of income. Personal use property is used by the taxpayer in activities which do not generate taxable income. This property is used in consumption activities. Such expenses are not deductible for income tax purposes because they represent the very thing that is designed to be taxed.[33] For example, rent paid on one's personal apartment is generally considered to be a consumption expense, as are amounts paid for food or entertainment.

Items that will continue to provide consumption benefits beyond the current year are known as consumer durables. If one buys an apartment instead of renting it, the expense is the purchase of a consumer durable because the benefits of the purchase will presumably last beyond the current year. As with regular consumption expenses, expenditures for consumer durables are not deductible because such expenditures are viewed as not for the production of income[34] but rather for consumption. Generally gains on the sale of consumer durables are includible in income,[35] whereas losses from the sale of these assets are not deductible.[36] Losses from the sale of consumer durables are generally viewed as consumption expenses.[37] For example, the reduction in the value of a car reflects the fact that the amount of consumption use remaining has decreased because some of it has been used by the taxpayer. There are exceptions to the inclusion of gain on consumer durables (such the exclusion for the sale of the house)[38] but the argument in favor of these provisions has little to do with properly measuring income. These rules are justified as an attempt to encourage productive behavior.[39]

The purchase of these consumer durables in essence receives a tax preference as compared with renting or leasing the same property. The tax preference results because the income tax code does not tax imputed income from owning a consumer durable. To understand how this imputed income arises, one has to

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32. I.R.C. §§ 162, 212 (2000).

33. SIMONS, *supra* note 7 (referring to the Haig-Simons definition of income: consumption plus change in net wealth).

34. SANFORD M. GUERIN & PHILLIP POSTLEWAITE, FEDERAL INCOME TAXATION 715 (1998).

35. *Id.* at 716.

36. I.R.C. § 262 (2000).

37. GUERIN & POSTLEWAITE, *supra* note 34, at 715.

38. Currently an individual taxpayer can exclude up to $250,000 of gain on the sale of a primary residence and married couples can exclude up to $500,000 of gain.

39. Here, to encourage home ownership; *see* discussion of Pigouvian taxes *infra* Part I.C.

view the purchase of a consumer durable as a form of investment. This investment gives returns of two kinds. First, it gives a monetary return when and if the asset is sold. Second, it gives returns in the form of the use of the asset for which the individuals would otherwise have to pay. This second form of return is equal to the amount of rent the individual would have paid to lease the item. This imputed return is generally not subject to tax. Because this imputed income is not subject to tax, the purchase of the asset is tax-favored.

To illustrate this, consider two hypothetical taxpayers. The first taxpayer invests $400,000 in securities which produce a return of 10% a year, and the taxpayer uses after-tax returns to rent a house. If the income on the investment is taxed at a 30% rate, then the amount of rent that the securities can support is $28,000 (40,000 x .7 = 28,000). On the other hand, consider a different taxpayer who purchases the house for $400,000.[40] The taxpayer pays no tax on the imputed value of the house. If the house earned a 10% return as well, because this return is not taxed, it can support a higher rent of $40,000. The taxpayer would have an incentive to purchase a house rather than invest in securities and rent a house.[41]

One might initially think that losses on consumer durables should be deductible because the total net wealth of the taxpayer is reduced by such losses. However, as discussed above, much of the loss on personal property is disallowed because the decrease in value of the asset is really a consumption expense.[42] Therefore, any deduction for losses on personal property must result from losses that occur from unexpected events rather than planned for consumption.[43] If one suffers a loss that does not result from consumption, that loss represents a reduction in income.

One might argue that, unlike property used for the production of income, a large portion of the returns from personal property are not subject to tax,[44] because there is no corresponding casualty gain provision, and allowing the losses to generate tax benefits would create an asymmetrical treatment of gains and losses on personal property. However, if the consumer durable is sold at a gain, this gain generally will be taxed and so, strictly speaking, it is not true that casualty gains always escape taxation.[45] There may be a timing advantage to the

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40. The analysis here assumes an efficient investment market. That is, if housing assets have lower returns, then they have lower risks, and if corporate stocks have higher returns, they thus have higher risks.

41. The United Kingdom experimented with taxing the imputed income from housing, but this was very unpopular and was repealed. *See* JOSEPH M. DODGE, THE LOGIC OF TAX 312-13 (1989). What will likely happen in the situation in the example is that the taxpayer will invest in housing until the return on housing drops to the after-tax rate of other assets. *See* Boris Bittker, *Equity, Efficiency and Income Tax Theory: Do Misallocations Drive Out Inequities?*, 16 SAN DIEGO L. REV. 735 (1979).

42. *Id.*

43. GUERIN & POSTLEWAITE, *supra* note 34.

44. UTZ, *supra* note 17.

45. If the item is never sold, it will not be taxed, but then has the taxpayer in fact experienced

way gains versus losses are treated, in that such gains are included only when the property is sold, whereas casualty losses are deductible in the year in which they occur. However, such gains are taxed; therefore, there is no inconsistency.[46]

The notion behind the rules for the casualty loss deduction is that once the loss exceeds the consumption use of the property, loss really represents a loss in net wealth, and so should be allowed as a net deduction. The mechanics of this provision are that, to the extent that the total casualty losses for the year exceed 10% of the adjusted gross income,[47] these losses can be deducted. Furthermore, each casualty loss is deductible only to the extent that it exceeds $100.[48] The loss must be the result of some sudden and unexpected event such as theft, hurricane, flood, earthquake, or terrorist attack.[49] To the extent the loss is covered by insurance, it is not deductible.[50]

The cost of insurance for losses on such property is not deductible.[51] Rather, this cost is viewed as a consumption expense. To compensate a deductible loss would be illogical. The insurance premium is simply the expected value of the loss. Because such losses may be deductible[52] but insurance premiums are not, the tax rules encourage self-insurance of these losses. This rule might decrease the desire of individuals to take out insurance because of the insurance provided by the tax system.[53] To illustrate, assume the taxpayer has an asset worth $100 but which has a 10% risk of loss with a $100 replacement cost.[54] The expected real cost of the asset is then $100 + $10 (10% of $100). The alternate way to address the cost is to insure the loss, for which the actuarially fair premium is $10.[55] Hence, a risk-neutral investor would be indifferent between insuring the loss and not insuring it. However, if the loss is deductible but the insurance is not, there is now an incentive to self-insure the loss. If the tax rate is 30%, then the after-tax loss is only $70, yielding an expected cost of $7, but the after-tax cost of the insurance is still $10. Thus the current rules distort the decision in

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a gain?

46. GUERIN & POSTLEWAITE, *supra* note 34.

47. Adjusted Gross Income, or AGI, is defined by I.R.C. section 62 as gross income (I.R.C. section 61 defines this as essentially gross receipts) minus the expenses incurred in producing these gross receipts.

48. Furthermore, these deductions are itemized deductions, so that they are also subject to the limits imposed on itemized deductions in I.R.C. sections 67 and 68.

49. Popa v. Commissioner, 73 T.C. 130 (1979).

50. I.R.C. § 165 (c)(3) (2000).

51. GUERIN & POSTLEWAITE, *supra* note 34.

52. I.R.C. § 165(c)(3) (2000).

53. Kaplow, *supra* note 19.

54. To keep this simple, we will assume that there is no chance that the replacement property will be destroyed. If it too had a 10% chance of destruction, this would translate into a 11.11% increase in the cost rather than a 10% increase in the cost.

55. The actuarially fair premium is the expected value of the loss, which here is $10 (or .1 X $100).

favor of not insuring property against casualty events.[56]

As one might expect, the recovery from the insurance company is not included in income.[57] If the taxpayer has suffered a loss and the insurance compensates the taxpayer for this loss, the taxpayer has not had a gain, but rather is in the same position as before the incident. Hence, the taxpayer has not increased her command over society's resources.

3. Tort Recoveries.—In general, tort recoveries which arise from physical injuries are excludible from income,[58] whereas tort recoveries from non-physical injuries, such as defamation and anti-trust, are generally includible in income.[59] Payments for destruction of property are examples of payments for non-physical injuries.[60] In this case, payments for the physical capital are excluded, but payments for lost income are includible in income. If the origin of the claim is a physical injury, recoveries for lost wages are excluded even though such recoveries would have been included in income had they been actually earned.[61]

Recoveries for pain and suffering are excluded from income. Pain and suffering recoveries are intended to be equal to the utility lost by the accident.[62] While wealth has increased as a result of the recovery, the tort victim is no better off after the recovery than before the accident.[63] Therefore, pain and suffering recoveries are not included in income, because they do not really improve the recipient's situation. The exclusion of such rewards is analogous to exclusion of casualty recoveries from insurance.[64]

4. Medical Expenses.—The treatment of medical expenses is in many ways similar to the treatment of losses on personal property. Routine medical expenses (for things like check-ups, etc.) are treated as consumption expenses which are not deductible because they are simply a cost of living. However, if severe medical problems occur, for example some catastrophic disease, then the expenses incurred to treat this condition are viewed as representing a loss to the ability of the taxpayer to consume and hence should be deductible.

Under the Internal Revenue Code, medical expenses are generally deductible. However, they are subject to a floor of 7.5% of adjusted gross income.[65] Self-employed individuals are also allowed to deduct a portion of the amount they pay for medical insurance. For tax years 2004 and following, the full amount of medical insurance will be deductible by self-employed individuals.[66] While there are differences, this system is in many respects rather like the casualty loss

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56. Kaplow, *supra* note 19.
57. I.R.C. § 104(a) (2000).
58. *Id.*
59. GUERIN & POSTLEWAITE, *supra* note 34, at 716.
60. *Id.* at 717.
61. *Id.*
62. Griffith, *supra* note 19.
63. *Id.*
64. Kniesner & Ziliak, *supra* note 2.
65. I.R.C. § 105 (2000).
66. *Id.*

system, where routine expenses are treated as consumption, while severe losses are treated as real reductions in net wealth. One key distinction between medical expenses and casualty losses is the treatment of the costs of insurance. Insurance for casualty losses on personal property are generally not deductible; however, medical insurance payments are generally either deductible or excludible.[67] Medical insurance when paid by the employer is both deductible to the employer as compensation and generally not includible to the employee (the equivalent of deductibility).[68] Furthermore, recoveries under medical insurance are not includible; thus, medical payments covered by insurance that are below the 7.5% of adjusted gross income threshold are treated more favorably than self-insured amounts.[69] The tax system therefore encourages the purchase of medical insurance. This is the reverse of most casualty losses, where self-insured losses are often treated more favorably than insured losses.[70]

5. Special Provisions Dealing with Losses from Terrorism.—There are very few provisions of the Internal Revenue Code that apply specifically to victims of terrorist acts. The most recent of these provisions are found in the Victims of Terrorism Tax Relief Act of 2001. The Victims of Terrorism Tax Relief Act of 2001 applies to victims of the Oklahoma City Bombing, the September 11 attacks, and bioterrorism involving anthrax between September 11 and January 1, 2002.[71]

The provisions of the act include:

(i) income waived for year of death and at least one prior year, with a minimum benefit of $10,000 per victim;
(ii) $3 million in assets shielded from federal and state estate tax plus $8.5 million in assets for 2001;
(iii) exclusion for workers' compensation benefits, death benefits, payments from government retirement plans, and payments from employer due to terrorism attack;
(iv) charitable payments exempt;
(v) forty percent excise tax on beneficiaries of structured settlements who cash out unless court approved;
(vi) exemption for disaster relief payments; and
(vii) additional authority for Treasury secretary to waive Internal Revenue Code provisions.

The Act only applies to those who die as a result of the attacks. It essentially extends the tax benefits that apply to soldiers who die in combat area to civilians

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67. *Id.*

68. *Id.*

69. Almost ironically, the deductibles on insurance recoveries (i.e., amounts actually paid by the taxpayer) might easily not be deductible.

70. *See* discussion *supra* Part I.B.2.

71. FBI experts have stated that the terrorist responsible for the anthrax cases appears to have been a domestic microbiologist, so there may be a different policy applicable in the case of the anthrax poisonings. Laura Parker, *Anthrax Probably Domestic: Investigators Focus in U.S. Laboratories*, USA TODAY, Dec. 18, 2001, at 1A.

who die as a result of terrorist attacks against the United States.[72] One of the main justifications for these provisions was that such civilians have been put in the same position as combat soldiers because, in the words of Rep. William M. Thomas (R-CA), Chairman of the House Ways and Means Committee, they "took it on the chin for America."[73]

In connection with an earlier terrorist attack, Congress passed the Aviation Security and Improvement Act of 1990[74] (which never became part of the Internal Revenue Code), granting income tax exemptions to taxpayers who died as a result of the Pan American Airways Flight 103 Terrorist disaster over Lockerbie, Scotland, for the year of the attack and the prior year. As with the Victims of Terrorism Relief Act, this act was targeted to victims of specific terrorist attacks.

The only provision in the Internal Revenue Code which applies specifically to acts of terrorism in general (as opposed to specific incidents) is found in I.R.C. section 104(a)(5). That provision exempts from income tax amounts received as disability income attributable to injuries incurred as a direct result of a violent attack which the Secretary of State determines to be a terrorist attack and which occurred while the injured individual was an employee of the United States engaged in performing official duties outside of the United States. Normally such receipts would be includible as lost wages.[75]

C. Effects of the Current Tax Rules on Behavior

As discussed earlier, the income tax provides a form of insurance.[76] If a taxpayer incurs a loss that is deductible, then the taxpayer really only suffers a loss equal to the amount of the loss multiplied by (1- the tax rate). Of course, if the loss is only partially deductible, then the actual loss to the taxpayer is increased to the extent the loss is not deductible.

As also stated earlier, it is generally assumed that the tax system should alter the behavior of taxpayers as little as possible.[77] However, many provisions selectively violate these neutrality principles.[78] The primary line of analysis that justifies using the tax system to alter the behavior of taxpayers argues that, where

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72. *Thomas-Rangel Bill to Provide Relief for Terrorist Attack Victims*, TAX NOTES TODAY, Sept. 20, 2001, at 183-91. I.R.C. section 112 allows an exclusion from taxable income for income earned while in a combat zone or while hospitalized from injuries received in a combat zone.

73. *Id.*

74. Pub. L. No. 101-604, 104 Stat. 3081 (1990).

75. The Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21 (2002). Businesses that qualify are those that either are located in the New York Liberty area (near the World Trade Center) and chose to stay or those that had to relocate from that area. It allows a credit of 40% up to the first $6000 of salary for those working more than 400 hours before Jan. 1, 2003. This is not subject to tax credit limitation of section 38. This act did not modify the Internal Revenue Code.

76. Griffith, *supra* note 19.

77. Chorvat, *supra* note 18.

78. For examples, see UTZ, *supra* note 17.

a particular behavior results in externalities to others, and the rules are designed to make the taxpayer account for the effects of their behavior on others, these changes can be improve efficiency. This theory was put forth by A.C. Pigou.[79] Consequently, taxes which are designed to account for externalities are known as Pigouvian taxes. The most common illustration of Pigouvian taxes is an effluence or pollution tax. If the polluter is assessed a tax equal to the costs imposed on others, the optimal level of pollution should result. The converse of this analysis argues that benefits should be given by the government to those who engage in socially productive behavior in which the individuals who engage in the behavior do not receive a share of the benefits proportional to their contributions. If, for example, a person builds a school for the community, because the benefits to the community are not captured by the builder, the government should provide a benefit to the builder.

From the perspective of an individual taxpayer, it is difficult to argue that losses from terrorism are somehow worse than other losses to which individuals are subject. Death is an ever present possibility, as is the loss of property and other assets. Therefore, any special tax rules for losses from terrorism should be based on some theory beyond the accurate calculation of income. Pigouvian analysis is therefore a helpful framework to justify such provisions.

Providing additional security to protect one's person, family, or business against terrorist attack creates a number of externalities for others. Most notably, a network of persons providing security against terrorism increases the security of each member beyond that which the expenses of an individual actor could create.[80] These expenses can therefore create positive externalities for others. These benefits are not likely to be accounted for in the calculation of deciding the appropriate amount of security unless some coordination occurs. Therefore, if the government causes each actor to receive more of the benefits he or she confers upon others, each actor will face more appropriate incentives.

The increased expenses which businesses will have to bear as a result of terrorist attacks include increased security. Security expenses may not be provided at the optimal level because of possible externalities which result from the very act of providing security.[81] That is, because those who are providing security do not receive all of the benefits, they may very likely under-provide security. Because protecting oneself can generate significant externalities, they must be accounted for and actually encouraged.[82]

If greater insurance benefits are provided for risks from terrorism, less of the risk of terrorism will remain with individuals. If less risk remains with individuals, one might argue that we may be creating moral hazards for the behavior of these individuals. Because individuals and corporations will not face as great a cost, they may take fewer precautions against becoming victims of terrorism. On an individual level this seems ridiculous. However, such

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79. ALEXANDRE C. PIGOU, A STUDY IN PUBLIC FINANCE 61 (3d ed. 1942).

80. KUNREUTHER & HEAL, *supra* note 3.

81. *Id.*

82. *Id.*

insurance is far from perfect. No insurance can ever fully make up for the loss of one's life or the life of a loved one.[83] Therefore, the degree of moral hazard created is rather minimal. The majority of the risk will always rest with the taxpayer. Further, as long as the tax code deals symmetrically with losses from terrorism and expenses to protect against terrorism, no moral hazard is created. In that case, the individual actor will face $(1-t)\%$[84] of the costs of being a victim as well as $(1-t)$ % of the costs of providing security. That is, the tax system will symmetrically reduce the costs of taking precautions against loss as well as the potential loss itself.

II. ANALYSIS OF THE EFFECTS OF THE TAX RULES ON INSURANCE COMPANIES

This section examines the effects of the tax rules on those whose business it is to mitigate risks: insurance companies. It concludes that the current tax system creates some inappropriate incentives. In particular, it creates disincentives to insure against events which result in large-scale losses. This section first examines the tax rules that apply to insurance companies. Then, it examines the effects of the rules on behaviors that relate to losses from terrorism.

A. Taxation of Insurance Companies

The most striking loss from terrorist attacks is clearly the loss of life. However, because the 3,000 or so deaths did not significantly change the rate of death in this country,[85] life insurance companies did not face the problems of other insurers.[86] From an insurance perspective, the most troubling losses were those of property. Attack-related losses caused the entire casualty insurance industry to suffer losses. The losses incurred in the terrorist events of 2001 exceeded the profits of the insurance industry for five years.

The taxation of casualty insurance companies is similar in many ways to the taxation of other businesses. Premiums,[87] as well as income earned by investments, are included in income[88] and the payouts on the insurance policies are deductible.[89] For years in which losses not only exceed current income but also exceed income for the last three years,[90] losses do not generate a current tax benefit. Such losses can be carried forward and reduce the tax owed in future years. The net present value of the future benefits is reduced compared to

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83. An exception to this would involve those who commit suicide to earn insurance money, something few are interested in doing.

84. The quantity $(1-t)$ is the proportion of a deductible expense which remains with the taxpayer.

85. Approximately twice as many people as that die every day. Woo, *supra* note 1.

86. This assumes that such large-scale events are unlikely to become very common or that the pattern of terrorism, to strike at symbols rather than population centers, holds.

87. I.R.C. §§ 831, 832 (2000).

88. I.R.C. § 831 (2000).

89. I.R.C. § 832 (2000).

90. I.R.C. § 172 (2000).

obtaining a current benefit. So in years in which the insurance companies incur large losses, the value of the losses for tax purposes is less than their full value, because they may not generate a current tax benefit. The timing effect caused by these limitations can have a significant effect on the value of tax benefits.[91] In fact, empirically, the value of the losses is on the order of three-fourths of the value one would estimate from a simple calculation of the tax rate multiplied by the loss.[92] This creates an incentive to spread the losses to more diversified pools of losses.[93] However, when the profits of the entire industry for a year or two are wiped out, as they were from the events of September 11, there is a large loss which cannot be diversified.[94] Market risk cannot be diversified, and when losses affect the entire casualty industry,[95] insurance companies which can often behave in a risk-neutral manner behave in a risk-averse manner.[96] The natural result of this is that insurance companies will increase insurance premiums and, as a result, will increase the risk aversion of the entire system.[97] Therefore, there will be a tax disincentive to insure large catastrophic losses.

The rules that apply to life insurance are more favorable. The taxable income of life insurance companies includes premiums received and companies are allowed to deduct death benefits paid, reserve increases, policy holder dividends paid, and the operations loss deduction from income.[98] Life insurance companies are also permitted to deduct a reserve for expected losses.[99] This deduction serves to smooth out losses, because they are booked at expected value, rather than having to wait until they are actually paid out. As discussed above in conjunction with casualty insurers, waiting for actual deaths could create a great deal of variation in deductions from year to year.[100]

B. Effects on Risk-Taking

One of the most interesting conclusions in the public finance literature argues

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91. Saman Majd & Stewart Myers, *Tax Asymmetries and Corporate Tax Refunds*, *in* EFFECTS OF TAXATION ON CAPITAL ACCUMULATION (Martin Feldstein ed., 1987).

92. *Id.*

93. This would smooth out the deductions among different tax years. The expenses would be the premiums paid to the re-insurer and this would occur each year, rather than when the losses occurred. *See* RICHARD BREALEY & STEWART MYERS, PRINCIPLES OF CORPORATE FINANCE (6th ed. 2001); *see also* I.R.C. § 831 (2000).

94. Woo, *supra* note 1.

95. BREALEY & MYERS, *supra* note 93.

96. *Id.*

97. For an argument that the risk aversion of the total system should be increased by the tax system than rather be decreased, see *infra* note 121 and accompanying text.

98. I.R.C. § 804 (2000).

99. *Id.*

100. William Beaver & Maureen McNichols, *The Characteristics and Valuation of Loss Reserves of Property and Casualty Insurers*, 3 REV. ACCT. STUD. 73 (1998).

that a "pure income tax" can result in more risk-taking by individuals.[101] Under this line of analysis, if an income tax with full-loss offsets[102] is imposed, it will result in greater investment in risky assets by taxpayers.[103] As explained more fully below, these investment shifts occur because such an income tax shifts some of the risk of a taxpayer's investments to the government. This risk shifting results from the government sharing both in the income and the loss of an investment to the same extent.[104] Taxpayers are essentially able to eliminate the tax burden on capital income by shifting more capital to risky assets.[105]

This analysis was first put forth by Evsey Domar and Richard Musgrave.[106] They made a number of assumptions in their model. First, as stated above, they assumed the income tax has full loss offsets. Second, they assumed that investments have constant marginal returns.[107] Third, they assumed that transactions costs are zero.[108] Many economists believe that the Domar-Musgrave model describes the U.S. economy.[109]

Under the Domar-Musgrave model, an income tax will cause investors to increase the amount of capital allocated to risky investments. The key notion behind these results is that an income tax reduces both the expected return of an investment and the variance (or risk) of the investment proportionately. If the marginal rate of return is constant, investors can return to their pre-tax rate of

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101. Louis Kaplow, *Taxation and Risk-Taking: A General Equilibrium Perspective*, 42 NAT'L TAX J. 457 (1994).

102. This means that if losses are incurred, the tax benefits obtained are symmetrical to the tax costs of earning income (e.g., if there is $100 of income and the tax rate is 30%, the taxpayer pays $30 in tax, but if there is a $100 loss, the taxpayer receives $30 from the government).

103. This hypothesis was first formulated in Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q.J. ECON. 388 (1944). *See generally* M.G. Allingham, *Risk-Taking and Taxation*, 32 ZEITSCHRIFT FÜR NATIONALÖKONOMIE 203 (1972).

104. Under a pure income tax, if a taxpayer has $100 in pre-tax income, $30 or 30% is given to the government. If the taxpayer has a $100 loss, under a pure income tax there are full loss offsets, so the taxpayer will obtain a benefit (either a check from the government or a reduction in taxes of $30). Hence, the government will share in both the loss and the gain to the same extent.

105. For an allied idea that income tax insulates consumption by providing insurance, see Kniesner & Ziliak, *supra* note 2.

106. They credit the insight to Henry Simons, although he did not formulate it in any systematic way in his writings. *See* A.B. Atkinson, *The Collected Papers of Richard A. Musgrave: A Review Article*, 33 J. PUB. ECON. 389, 394 (1987).

107. Constant marginal returns occur when the investor does not affect the return on an asset by investing more or less in that asset. One consequence of this assumption is that the prices of assets do not change as a result of the imposition of the tax. HAL R. VARIAN, MICROECONOMIC ANALYSIS (1990).

108. It is also assumed that the investor is risk averse. However, this follows from the fact that there is a premium for risk. For a discussion of this and other restrictions of the model, see Joseph Stiglitz, *The Effects of Income, Wealth and Capital Gains Taxation on Risk-Taking*, 83 Q.J. ECON. 263 (1969).

109. Chorvat, *supra* note 18.

return by shifting more capital to the risky asset. Under the Domar-Musgrave model, the true burden of an income tax is not the revenue paid to the treasury. If all the assumptions are met, there essentially is no burden of the tax to the taxpayer.[110] The income tax has effectively made the government a partner in the investments of the taxpayer.

It is easiest to illustrate the operation of the Domar-Musgrave model if we first assume the riskless rate of return is zero. This means that an investment that bears no risk of loss will not produce any income. Only an investment that has a risk of loss will produce a positive return. While this may seem unrealistic, most calculations of the real (i.e., inflation adjusted) riskless rate of return are very small.[111]

We assume that an investor has optimally invested his or her capital before any income tax has been imposed. An income tax imposed on the income from the assets in the portfolio would cause the risky asset to be proportionately less risky and have a proportionately lower rate of return. If the asset had a loss of $100 and the tax rate was 30%, then the after-tax loss would be only $70. Conversely, if the asset had a gain of $100, then the after-tax gain would be only $70. More generally, both the risk and the return on the investment are reduced to $(1-t)$ multiplied by pre-tax values of risk and return respectively, where t is the tax rate. By shifting more investments into risky assets, the taxpayer can return to pre-tax rates of return.[112] An investor can avoid the effects of an income tax by increasing the amount invested in the risky asset to $a/(1-t)$,[113] where a is the proportion of the portfolio invested in the risky asset prior to the imposition of the tax.[114] This result occurs with any tax rate below 100%, if there is a positive rate of return on the asset.[115]

For example, assume that an investor with $200 can choose between a riskless asset with a zero rate of return and a risky asset that will produce either a 30% gain (with a probability of 50%) or a 10% loss (with a probability of 50%), for a positive expected return of 10%[116] in a year. Assume that in a tax-

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110. The government is in effect taking on risk and being compensated for doing so. It is, in effect, issuing an insurance policy. *See* Kniesner & Ziliak, *supra* note 2.

111. The inflation adjusted risk-free rate of return from 1926 to 1996 was .6%. IBBOTSON ASSOCIATES, STOCKS, BONDS, BILLS, AND INFLATION: 1997 YEARBOOK 88 (1997).

112. Domar & Musgrave, *supra* note 103.

113. This is because the after tax rate of return is $(1-t)x$, where t is the tax rate and x is the pre-tax gain. The after-tax risk of the asset is also reduced to $(1-t)y$, where y is the pre-tax loss. If the taxpayer shifts $a/(1-t)$ to the risky asset, where a is the proportion of the portfolio in the risky asset before the tax was imposed, then the after-tax rate of return on the asset is ax or $(ax(1-t)/(1-t))$, and its risk is also ay or $(ay(1-t)/(1-t))$. If the shifts are made, the after-tax rates of risk and return are the pre-tax rates of risk and return.

114. *See* ANTHONY B. ATKINSON & JOSEPH E. STIGLITZ, LECTURES ON PUBLIC ECONOMICS 118 (1980); see Jan Mossin, *Taxation and Risk-Taking: An Expected Utility Approach*, 35 ECONOMICA 74 (1968) for an alternative derivation of this result.

115. *See supra* note 104. The proportion is undefined at 100%.

116. The calculation is: [.3 X .5] - [.1 X.5] = .1.

free world, the investor would divide the portfolio equally between the risky and the riskless asset (i.e., $100 in each). After a year, the riskless asset is still worth $100, and the risky asset is worth either $130 or $90. Hence, the investor will have a total of either $230 or $190, and an expected total return of $210.

Imposing a 30% income tax with full loss offsets will decrease the average return on an investment by the amount of the tax. However, it will also reduce the riskiness of the investment by the amount of the tax benefit (i.e., deduction, credit, etc.) that results from a loss.[117] The two effects combine so that an investor can avoid the effects of the 30% tax by increasing the amount allocated to the risky asset to $142.86 and reducing the amount invested in the riskless asset to $57.14. In that case, at end of the year, the riskless asset is still worth $57.14. After the income tax is paid, the risky investment will be worth either $172.86[118] or $132.86.[119] The investor will have a 50% chance of having a net worth of $230 and a 50% chance of having a net worth of $190 after taxes. The investor is in the same position as if there were no tax at all.

The government collects revenue from capital income even though the investor obtains the same return after the imposition of the tax as before the tax because the income tax has forced the investor to have a portfolio that is riskier on a pre-tax basis. While the private risk to the investor has not changed, total risk undertaken by society has. However, it is the government that bears the additional risk. In essence, the tax revenue is the compensation the government receives for taking the additional risk.[120]

Taxpayers are willing to take on more risk than would be the case in the absence of the tax. This Article will assume that the general level of risk that results from a perfect income tax is appropriate,[121] although there maybe some specific areas in which the income tax may not allocate this risk appropriately. There are good reasons for arguing that society might want to encourage additional risk taking from that which would occur in the absence of an income tax.[122] One important assumption made in the model is that losses can be utilized at their full value. The more reduced the ability of the taxpayer to currently

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117. If there are full loss offsets, then some kind of tax benefit must flow to the taxpayer when there is a loss. *See supra* note 104.

118. Here, the after-tax value of the risky asset is the after-tax rate of return ($1+(1-t)r$, where r is the pre-tax rate of return) times the amount of capital in the asset ($100/(1-t)$), which equals (1 + (1-.3).3) (100/[1-.3]) or 172.86.

119. Here, the value of the risky asset after-tax is the after-tax rate of return ($1+(1-t)r$) times the amount of capital in the asset ($100/(1-t)$), which equals (1-(1-.3).1)(100/[1-.3]) or 132.86.

120. Domar & Musgrave, *supra* note 103. If all of their assets in risky assets have already been invested, then the shift can be accomplished by borrowing. The government is essentially investing in a portfolio of stocks equal to $1/(1-t)$ of all the assets subject to the tax. This is the capital shifted into the risky assets. *See* discussion *infra* Part II.B.

121. Chorvat, *supra* note 18; *see* Terrence Chorvat, *Apologia for the Double Taxation of Corporate Income*, 38 WAKE FOREST L. REV. (forthcoming).

122. Chorvat, *supra* note 28.

utilize losses, the less investment will be shifted to riskier assets.[123] If the Code restricts the use of losses, it will reduce risk-taking behavior by the taxpayer.[124] Hence, because losses are restricted, in the case of insurance, underwriting companies will be more risk-averse than would otherwise be the case.

Fewer restrictions on deductibility of losses for insurance companies, for those risks and investments which are not likely to wipe out their profits, will result in greater acceptance of risk. By contrast, restricting the use of losses, where risks can wipe out insurance company profits, will create more risk aversion and hence higher insurance prices.

III. THE CASE FOR SPECIAL TAX BENEFITS TO IMPROVE PUBLIC POLICY

A. Improvement of Public Policy

While private parties can take precautions , in most instances the party who can most cost-effectively prevent terrorism is the government. The government has a greater knowledge of who potential terrorists are and where they are likely to strike. In general, while the government currently has many non-monetary incentives to prevent terrorism, by adding terrorism benefits to the tax system, the likelihood of an attack will have to be estimated and these facts and assumptions will have to be included in the public debate over the budget. Requiring the government to take a greater share of the losses would force decision-makers to reassess the potential risks and cause a more rational allocation of resources to prevent terrorism.

While it is not always clear that one can treat the government as a rational actor, governmental decisionmakers often do respond to incentives.[125] In particular, legislators and other government actors are more likely to be rational actors. Terrorism clearly imposes costs on parties other than the government, and it is also clear that the primary defense we have against terrorism is governmental action. Yet, because most of the loss is not borne by the government, arguably the government does not face the proper incentives to avoid terrorism. This argues for governmental insurance of losses caused by terrorism. Of course, the government already insures these losses to the extent of tax benefits that result from such losses.

Under public choice models of decision, legislators and other bureaucrats enact laws to further their own self-interest[126] While this description may not

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123. Stiglitz, *supra* note 108.

124. *See* Diderik Lund, *Taxation, Uncertainty, and the Cost of Equity*, 9 INT'L TAX'N & PUB. FIN. 483 (2002).

125. The key to rationality is acyclity of preferences, and Arrow's Impossibility Theorem shows that for democratic governments it can never be proven that the government will always act in non-cyclical manner. Nonetheless, it is fair to say that the government does behave in a manner with costs to it due to the choices, but it does act to minimize costs to some degree. NICHOLSON, *supra* note 28.

126. For a public choice analysis of defense spending measures, see RICHARD A. POSNER,

incorporate all aspects of how governmental decisions are made, the model possesses a fair amount of explanatory power. Legislators, as all individuals do, act to maximize self-interest. They will therefore enact legislation likely to get them re-elected. That is, actions that please contributors or large block of voters are going to be maximized. Public choice models show that, as a result, diffuse interests generally lose out to specific interests.[127] Here, the defense against terrorism represents a diffuse interest. The terrorist threats apply to very large segments of the population. Alternate interest groups are more likely to be focused and expend significant amount of resources on lobbying.[128] While one might expect that there would be a significant electoral penalty for allowing terrorist attacks, there appears to have been no political penalty for the acts of terrorism which occurred in the 1990s.[129] After September 11, the job approval ratings of most elected politicians increased. Therefore, it is not clear what pressure is placed on governmental decisionmakers to avoid terrorist attacks. On the other hand, if legislators react to budgetary pressures at all, causing terrorism to create budget pressure is more likely to result in governmental action.[130] Therefore, it is necessary to increase the costs decisionmakers face for failing to provide for security against terrorism.

B. Proposals

As discussed in Part I.B.5, the major provisions that specifically address terrorism apply only to specific terrorist events and were enacted after the occurrence of those events.[131] However, given that these events will likely happen in the future because they have happened in the past (although we can hope they will not), we should apply similar rules to all victims of terrorism. There are at least two benefits that will result from this. First, there are certain procedural benefits that will accrue to codifying these rules. Codifying this relief will result in terrorism costs becoming part of what is referred to as the "tax expenditure budget." This budget reports the "tax expenditures" contained in the Internal Revenue Code. That is, it reports the amount of tax revenue that is lost as a result of provisions in the Code which are not designed to accurately define

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ECONOMIC ANALYSIS OF LAW (1992); Dwight R. Lee, *Public Goods, Politics, and Two Cheers for the Military-Industrial Complex*, *in* ARMS, POLITICS, AND THE ECONOMY (Robert Higgs ed., 1990); *see also* Jeffrey Rogers Hummel & Don Lavote, *National Defense and the Public Goods Problem*, *in* ARMS, POLITICS, AND THE ECONOMY (Robert Higgs ed., 1990).

127. POSNER, *supra* note 126, at 749.

128. The explanation of this is related to the collective action problem. *Id.*

129. There were many terrorist events in the 1990s, including the first World Trade Center bombing, the Oklahoma City bombing, the bombing of the U.S. embassies in Kenya and Tanzania, and the bombing of the U.S.S. Cole.

130. If government budget spending were not a scarce resource, compromises would not have to be reached. NICHOLSON, *supra* note 28.

131. Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379, 1426 (1991).

income for tax purposes, but rather are designed to alter behavior in some ostensibly positive way. This is a budget prepared each year. Both the Joint Committee on Taxation and the Office of Management and Budget prepare their own versions of this budget. By including the expenses of terrorism within the budget, the expenses of providing defense against terrorism can be directly compared, and it will be more clear how to reach an optimal defense. Currently, only the costs of providing the defense are included in the process. Second, these expenses will be included in budget negotiations and the total amount government can spend on other projects without raising taxes will be limited.

As discussed earlier, forcing decisionmakers to face more of the costs of terrorism makes them more likely to provide a level of security closer to the optimum.[132] There are at least three ways for governmental decision-makers to face more of these costs. First, as discussed in Part II, because the tax system currently treats losses disadvantageously as compared to income, insurance companies should be allowed to more fully utilize the losses which are generated from catastrophic events. There are a number ways to accomplish this.[133] The most commonly discussed methods involve unlimited ability to carry losses back to earlier years,[134] the government paying interest on loss carryforwards, or allowing tax credits for losses. A second way would be to codify special benefits for victims of terrorist attacks. This will result in lower taxes to insurance companies and higher costs to government. These benefits would increase the costs of terrorist events and cause decisionmakers to devote more resources to defending against terrorism. Third, amounts expended on security to protect against terrorism should be given a tax preference, either by a credit which exceeds the tax rate multiplied by the amount of the expense or by other means. In so doing, we need to be careful not to distort decisions on how to provide security (e.g., capital intensive vs. labor intensive). One way to insure this would be to offer in addition to the deductibility of these expenses, a credit for these expenses of 40%. This rate is greater than the current after-tax value of the deduction for such expenses (35% for corporations). One has to note that the optimal level of this credit is ambiguous.

CONCLUSION

By providing additional compensation to victims of terrorism, the U.S. tax rules can significantly improve the efficiency of both the tax system and the entire U.S. economy. Incorporating the costs of terrorism can help to provide correct incentives for individuals, corporations, most importantly, governmental decisionmakers who are responsible for the national defense budget. At present, the costs of terrorism are allocated on an *ad hoc* basis, unsupported by principled economic theory.

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132. *See* discussion *supra* Part III.A

133. For a further discussion, see Majd & Myers, *supra* note 91.

134. This allows for a higher present value of these losses, because it is more likely to result in an immediate disbursement from the government.

Increasing the deductibility of losses for insurance companies will promote higher levels of lower-cost insurance, as well as positive externalities such as increased levels of security against terrorism. Moreover, increasing the deductibility of losses for *all* U.S. corporations will create positive externalities such as increased security measures that will promote an optimal level of security for society as a whole.

TERRORISM AND INSURANCE MARKETS: A ROLE FOR THE GOVERNMENT AS INSURER?

ANNE GRON*
ALAN O. SYKES**

ABSTRACT

Since September 11, 2001, insurance markets have been struggling to adjust to new information about the magnitude of risks posed by terrorism, and to the loss of tens of billions of dollars in reserves because of claims relating to the September 11 attacks. Insurance coverage for terror-related losses has become more expensive and for some risks difficult or impossible to obtain. As a result, various interest groups called for the federal government to provide coverage for terrorism losses, resulting in the Terrorism Risk Insurance Act of 2002. We question the wisdom of measures of this sort. They are likely to come too late to address short-term market disruption, and in the long run may well supplant or distort desirable market responses to the new information about terrorism risk.

The terrorist attacks on the United States in September 2001 created chaos in the insurance industry. Insurers immediately refused to sell more than minimal coverage to any airline for ground damage, placing airlines in difficulty with both creditors and regulators.[1] Property and casualty reinsurers, who will bear the brunt of the $40 billion or more in claims resulting from the destruction of the World Trade Center,[2] announced that they would no longer sell coverage for acts of terrorism. The insurance industry responded by announcing that acts of terrorism would be excluded from coverage under commercial policies in future renewals, a state of affairs that might place the owners of some commercial properties in breach of loan covenants and may leave commercial lenders hesitant to make new loans.[3]

The Bush administration quickly obtained temporary authority for the Federal Aviation Administration to provide insurance coverage to airlines for

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* Assistant Professor of Management and Strategy, Northwestern University, Kellogg School of Business. B.A., 1984, *magna cum laude*, Williams College; Ph.D., Massachusetts Institute of Technology.

** Frank and Bernice Greenberg Professor of Law, University of Chicago Law School. B.A., 1976, College of William and Mary; J.D., 1982, Yale University Law School; Ph.D., 1987, Yale University.

1. *See* Barbara De Lollis, *Airlines Plan to Create Insurance Company; Insurers Had Stopped Selling War Risk Policies After September 11 Coverage*, USA TODAY, Mar. 7, 2002, at 2B.

2. Jackie Spinner, *Insurers See Terror Coverage Delays Unless U.S. Helps*, WASH. POST, Jan. 18, 2002, at E3.

3. *See* Adrian Michaels, *Insurance Chief Warns U.S. Business of Cover Loss: Terror Attacks Widespread Disruption and Breaches of Loan Covenants Predicted Unless Legislation Passed*, FIN. TIMES (London), Dec. 6, 2001, The Americas, at 12.

ground damage,[4] a program that remains in force subject to periodic votes on renewal. Broader proposals for government participation passed both houses of Congress and were signed by President Bush in November 2002. The legislation provided federal coverage for up to 90% of the cost of a terrorist attack that creates losses in excess of $10 billion and up to a total of $100 billion for three years.[5]

This paper inquires whether a lack of insurance coverage for terrorist acts warrants government intervention, and in particular whether government should serve as the insurer of last resort going forward. Our answer to this question is a tentative "no." We stipulate at the outset that our general suspicion of government involvement rests more on empirical judgments, grounded in significant part on previous experiences with government as an insurer, than on tight theoretical arguments.

In brief, the problems with the affordability and availability of terrorism insurance can be divided into two categories. The first group of problems arises from the temporary capacity shortage attributable to the significant decline in industry capital following the events of September 11. These problems affect terrorism exposures of a low to moderately large magnitude which are diversifiable and thus would be insurable in a market not afflicted by a capacity shortage. Many of these temporary capacity shortages have occurred over the past several decades, with the most recent associated with catastrophe insurance in the early 1990s. These transitory periods of capacity shortage are often called insurance crises because they are characterized by large reductions in the availability of insurance (encompassing both increased deductibles and reduced limits) along with large price increases and, at times, a lack of coverage at any price for the lines most affected. The problems associated with the current capacity shortage are amplified because the events of September 11 occurred at a time when property-casualty insurance prices were already rising and insurers had significant risk overhang from other property policies in force. Those events caused insurers to revise upward their judgments about the probability of a terrorist act and the associated losses, but considerable uncertainty still exists about both. To manage this altered risk, insurers now want to rebalance their exposures geographically and better diversify their portfolios, a process which has made them reluctant to write new terrorism coverage.

The problems arising from a temporary capacity shortage and associated complications are short-term and can be expected to be self-correcting. For example, a little more than six months after the attacks, insurers were ready to begin writing some policies that they refused to sell six months earlier (such as substantial coverage for ground damage caused by airliners).[6] Barring new shocks to the market, this trend should continue and availability and pricing for

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4. *See* De Lollis, *supra* note 1.

5. *Bush Signs Terror Insurance Bill Sought by Industry*, SCRIPPS HOWARD NEWS SERV., Nov. 26, 2002.

6. Christopher Oster, *AIG Urges FAA to End Airlines' War Insurance*, WALL ST. J., Feb. 26, 2002.

some terrorism coverage will likely improve substantially (although premiums will assuredly be higher, reflecting the higher expected loss). Any further government participation in the market for coverage of these losses is likely unnecessary and may well be counterproductive.

We note also that some of the adjustment will occur on the part of insureds, not just their insurers. If loan contracts call for borrowers to carry "all risk" insurance, for example, and coverage for one of the risks encompassed by that term (terrorism) is no longer available, borrowers and lenders have the option of adjusting their contractual relationship. Lenders can simply reprice the loans upward and waive the requirement of terrorism coverage. For many properties where the risk of terrorism is extremely low, the price adjustment will be trivial. And for types of properties where the risk is perceived to be great, it is hardly obvious that the lending market should proceed as if September 11 had never happened—it may well be desirable for some commercial development to be curtailed or reoriented in response to the greater threat of terrorism that now exists.

A second set of problems relates to insurance for large-scale, catastrophic terrorist acts, such as the detonation of nuclear weapons in major cities. To be sure, these types of events will likely remain uninsurable. But that has always been the case. Readers need do no more than glance at their homeowners' policies for evidence. They will likely find among the losses not insured such items as losses due to "acts of war," enumerated to include such acts as the discharge of a nuclear weapon. Similarly, losses due to nuclear hazard are likely excluded from coverage.[7] As we discuss further below, it is not difficult to understand why private insurers do not cover such losses. The essence of insurance is risk pooling and diversification, so that aggregate losses become predictable and insurers can have a high degree of confidence that their premiums and investment income will cover their loss payouts and expenses. Coverage for the rare but massive losses that threaten insurers with insolvency will only be offered (if at all) at a hefty premium above their actuarial value, a premium that insureds will likely find excessive in relation to their willingness to pay to lay off risk, and doubly so if insurer default is a concern.

If the private market lacks the capital to write coverage for these large and nondiversifiable losses, should the government step in to supply it? The short answer is that the government does supply it in a sense, although not through formal insurance contracts. Federal aid to New York City following the recent terrorist attacks was authorized at about $25 billion. A compensation fund for victims has been established that will ensure each decedent's estate a six or seven figure payment. More generally, one would be hard-pressed to identify any large scale domestic catastrophe in modern times—whether flood, earthquake, volcanic eruption, or hurricane—where the federal government did not offer considerable aid after the fact.

The question then becomes a more subtle one—should the government enter

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7. One of the authors' Illinois State Farm Homeowner's Policy contains all of these exclusions (on file with author).

the insurance market ex ante and commit itself contractually to cover particular losses relating to terrorism, or should it instead rely on the private market to insure the diversifiable losses and step in with an appropriate aid package ex post in the event of something catastrophic and uninsured? We favor the latter approach, for three reasons. First, past experience with the government as formal participant in insurance markets is not comforting. The government rarely prices or manages risks as would a private insurer with sufficient capital, particularly when there is already a large constituency of policyholders and creditors advocating more coverage at lower prices. The result is a mix of subsidies, cross-subsidies, moral hazard and adverse selection that distort behavior, as well as improperly priced government insurance that may crowd out efficient private insurance. These distortions may well swamp any efficiencies from improved risk sharing. The "Terrorism Risk Insurance Act of 2002," passed by both houses of Congress in November 2002, is illustrative of the problem—the government will simply assume the losses incurred above a certain (rather low) aggregate, charging nothing for that protection and thereby subsidizing insurers who have already sold policies on the premise that they would have to cover at least some of those losses.[8] Although this program is ostensibly "temporary," political pressures to leave this subsidy in place may prove irresistible. The beneficiaries are well-organized groups of insurers, real estate developers, and the like, while the losers are the diffusely organized and perhaps poorly-informed group of taxpayers at large.

Second, given past experience with government accumulation of funds for future disbursement, there is little reason to think that such funds would be treated much differently than general revenues. If insurance premiums would likely be based on political rather than economic considerations, and if accumulated premium revenues would be treated as fungible with other revenue sources, we see little reason to set up a new apparatus for the collection of insurance premiums.

Finally, in the event of the most catastrophic type of terrorist attack, governmental resources may be severely strained. It is by no means clear that ex ante arrangements committing scarce resources to particular property owners will allocate those resources most efficiently even with a $100 billion cap on federal payments as enacted..

In offering these tentative judgments about the wisdom of government involvement, we are not unmindful of the evidence that a lack of terrorism coverage is presently causing genuine disruption in some markets. The press is replete with anecdotal references to project financing that is on hold because "all risk" coverage is unavailable. President Bush has cited the example of a large Nevada resort development that cannot obtain financing, and mortgage bankers and real estate developers seem widely supportive of government stepping into the breach.[9] But it simply does not follow that government should act. The real

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8. Ins. Info. Inst., Hot Topics and Insurance Issues: Terrorism and Insurance, *at* http://www.iii.org/media/hottopics/insurance/sept11/.

9. Mark A. Hoffman, *Bush Renews Push for Terror Cover Aid*, BUS. INS., Apr. 15, 2002.

estate industry and the lenders that support it would of course like to return to the days before September 11 when terrorism risk was perceived to be a de minimis cost of doing business, and they will happily support programs to shift the increased risk to taxpayers. But terrorism risk is a cost like any other that ought to be internalized by developers, not externalized. If it cannot be laid off on insurers for the time being at a price that developers find congenial due to a capacity shortage, it does not follow that government should assume the risk instead. The optimal response to the short-term insurance crisis may well be for lenders and borrowers to revise their contracts to recognize that insurance is temporarily unavailable, and to reprice them accordingly. In the long term, any lasting policy exclusions for catastrophic losses due to terrorist acts should be no more disruptive to project finance than exclusions for acts of war, which have persisted without causing any great difficulty for decades.

The sections that follow develop and refine these arguments. We begin with some positive economics on the insurance industry and the "capacity constraints" that afflict it in times of uncertainty following large shocks, as well as some history relating to previous insurance "crises."

I. THE ECONOMICS OF INSURANCE "CRISES"

Crises in the availability of private insurance coverage are not unfamiliar. During the 1980s, certain lines of liability insurance increased in price spectacularly, and a few became altogether unavailable (such as certain lines of medical malpractice coverage).[10] The most recent crisis occurred in the early 1990s following Hurricane Andrew when reinsurers exited the market for coverage of catastrophic risks, leading domestic casualty to insurers to fear that another major disaster might threaten their solvency.[11] Such crises also produced political support for governmental actions to reduce insurers' exposure to risk, and indeed one can trace some modern tort reforms and initiatives such as the California Earthquake Authority in part to these episodes.[12] The liability and catastrophe insurance crises also spawned a fair amount of theoretical and empirical research into the reasons for them.

A. The Theory of Insurance Capacity Limits

The insurance crises of the past, as well as the present situation with respect to terrorism coverage, all arose following large, unanticipated losses for insurers. At first blush, the unwillingness of insurers to sell coverage at such times, or a large increase in required premiums relative to expected losses, presents a puzzle. After all, insurers are in the business of bearing risk, and it is not obvious why an increase in the riskiness of their business would give them pause—premiums

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10. *See* George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1521, 1522, 1527 (1987).

11. *See generally* THE FINANCING OF CATASTROPHE RISK (Kenneth A. Froot ed., 1999).

12. Regarding the latter, see generally David A. Moss, *Courting Disaster?: The Transformation of Federal Disaster Policy Since 1803*, *in id.* at 307.

will rise when the expected value of covered losses rises to be sure, but why should insurers refuse to write coverage at all or charge premiums far in excess of expected losses? Instead, one might expect insurance actuaries to take their best guess regarding future expected losses as new information comes in, and to make coverage available for a premium that covers expected costs.

Insurance crises are part of a larger pattern of pricing and availability in insurance markets, sometimes referred to as the insurance cycle. During the crisis phase, the most affected lines of business experience rapidly increasing prices accompanied by severely restricted quantity. Coverage may become unavailable for a very few types of losses and insureds. During this time most insurers realize great improvements in profitability and are able to increase their capital from retained earnings. Over time, the crisis phase or tight market lessens and prices may fall as the availability of coverage significantly increases. This period of relative stability typically gives way eventually to a soft market where prices are quite low, availability is abundant, and insurer profitability is quite low. The soft market generally persists until another large, unanticipated industry loss reduces industry capacity to the point where another crisis arises.

Various theories have emerged through the years to explain insurers' behavior during tight markets. Some economists argued that tightness was due to foolish loss forecasting that underpredicted losses during periods of rising losses and overpredicted them during periods where losses had stabilized, rather akin to the famous "cobweb" model of naive price forecasting in elementary microeconomic theory.[13] The difficulty with this theory, of course, is that it relies on perpetual stupidity on the part of insurance actuaries, not a very appealing assumption. It also fails to explain why insurance coverage might become unavailable altogether.

Others have suggested that regulatory drag contributes to cycles, with periods of increased losses followed by periods during which regulators constrain the ability of insurers to write coverage in order to protect solvency.[14] These theories primarily aim at explaining the time series pattern of profitability across the cycle and are not well suited to explain the quantity changes associated with profit movements over the cycle. The claim that regulation is the central reason for cycles is at best incomplete. Reinsurance markets are largely unregulated, for example, yet some of the most prominent "crises" (including the catastrophic risk situation in the early 1990s and the dearth of terrorism coverage) arose from an unwillingness of reinsurers to write coverage.

With particular reference to the 1980s' liability crisis, still other writers suggested that adverse selection in the commercial casualty market was the problem. As losses grew due to changes in liability rules, the story ran, the difference in risk exposure between "good types" and "bad types" increased, leading more "good types" to exit the insurance market leaving behind "bad

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13. *See generally* Emilio C. Venezian, *Ratemaking Methods and Profit Cycles in Property and Liability Insurance*, 52 J. RISK & INS. 477 (1985).

14. J.D. Cummins & J.F. Outreville, *An International Analysis of Underwriting Cycles in Property-Liability Insurance*, 54 J. RISK & INS. 246, 250 (June 1987).

types" and higher premiums.[15] This theory has some explanatory power, but has a more difficult time with crises in other lines of insurance such as the recent catastrophe insurance crisis in the early 1990s (where adverse selection seems much less of a problem), and it does not explain some elements of the 1980s' liability crisis. For example, many liability policies were canceled during the crisis, but adverse selection should not cause insureds or insurers to cancel insurance that is sold before the market begins to unravel.[16] In addition, if the market was unraveling during the liability insurance crisis, why did total premiums collected approximately triple?[17] An unraveling market should produce a drop in premiums.[18]

Another line of theory emphasizes capital market constraints on insurers as an explanation for tightness in the market.[19] The key assumption is that external capital is more expensive than internal capital. For insurance companies in particular, it is likely that the capital markets will be suspicious of insurers trying to raise capital in the face of a recent increase in loss payouts. Some such insurers may simply be seeking the reserves needed to write profitable new policies, but others may be hoping to externalize the costs of expected future losses to unwitting new investors. If investors have difficulty telling these categories of insurers apart, all insurers may pay a hefty risk premium for outside capital, especially following a substantial increase in covered losses.

In general, when external capital is more expensive than internal capital, the value of any firm is likely to be concave in internal capital, causing the firm to act as if it is risk averse.[20] This situation arises from the fact that some positive value investment projects will be profitable if financed using internal funds but not if financed using external funds. A reduction in available internal capital thus reduces the firm's willingness to undertake some new investment projects, while an increase in internal capital makes more projects profitable. Because investment opportunities exhibit diminishing returns, however, a reduction in internal capital is more costly than a comparable increase in internal capital, producing the concavity noted above. Significant bankruptcy costs can produce a similar result.

An insurer operating under these conditions will act as if it is risk averse and will manage its insurance portfolio to reduce the variance of the returns.[21] As a

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15. *See* Priest, *supra* note 10, at 1562; Ralph A. Winter, *The Liability Insurance Market*, 5 J. ECON. PERSP. 115, 123, 124, 131 (Summer 1991).

16. *See* Anne Gron & Andrew Winton, *Risk Overhang and Market Behavior*, 74 J. BUS. 591, 606 (2001).

17. *See* Winter, *supra* note 15, at 126 (reporting that net premiums written rose from $6.5 billion to $19 billion during the 1984-86 episode).

18. *Id.*

19. *See* Anne Gron, *Capacity Constraints and Cycles in Property-Casualty Insurance Markets*, 25 RAND J. ECON. 110, 112 (Spring 1994); Gron & Winton, *supra* note 16.

20. Gron & Winton, *supra* note 16, at 594, 607.

21. The same argument applies to the typical corporation, offering an explanation of why otherwise risk neutral firms purchase insurance and engage in other forms of risk management. A

result, the insurer will require a positive risk premium to assume risks that are positively correlated with other risks in the portfolio (a negative "risk premium" is also possible as to risks that are negatively correlated with the other risks in the portfolio).[22] Insurers who effectively diversify their insurance portfolios will be able to offer lower prices (for a given probability of bankruptcy). Competition among insurers will thus lead insurers to manage their insurance portfolios to diversify risks either by directly adjusting their exposures sold or by the use of various types of reinsurance.[23] As a result, the risk premia required by different insurers for the same type of risk will tend to converge.

With this background, it is easy to see how internal capital affects the "capacity" of the insurance industry. The capacity theory of cycles posits that insurance crises arise from a temporary shortage of industry capital. To go from the firm level discussion above to what happens at the industry level, note that because each insurer's ability to bear risk is related to its individual level of capital, the aggregate risk that the industry will assume at a reasonable probability of solvency is related to the aggregate level of capital that insurers have in the short run.

The level of capital in the industry is subject to random shocks arising from shocks to asset values and unexpected loss realizations. Unexpected losses can come from several sources but often arise when insurers have underestimated the probability or severity of large losses. Unusually large and unexpected declines in industry capital will result in a temporary capacity shortfall. After a large shock that changes the perceived probability distribution of losses, insurers will update their estimate of their existing exposure to risk associated with policies currently outstanding. Because of their limited capital and increased exposure to the risk in question, insurers will require a larger risk premium to bear additional risk of this sort.

Many insurers may want to cede this risk rather than assuming more. If reinsurance is available, insurers can rebalance existing exposures relatively quickly.[24] But if the reinsurance industry is also experiencing a temporary capital shortage and an increased exposure to the risk, as is typically the case, insurers (and reinsurers) may rebalance their exposures to the risk by waiting until existing policies expire and not renewing, or, in the extreme, they may cancel existing policies when cancellation is contractually possible.[25] This situation has been termed "risk overhang" in the literature.[26]

The problems from these capacity shortages tend to diminish over time for

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full discussion of the motivations for corporate risk management are beyond the scope of this paper. For more on the portfolio approach to corporate risk management, see Kenneth A. Froot et al., *Risk Management; Coordinating Corporate Investment and Financing*, 48 J. FIN. 1629 (Dec. 1993).

22. For a formal model of such an insurance market, see Gron & Winton, *supra* note 16, at 595, 596.

23. Priest, *supra* note 10, at 531.

24. Gron & Winton, *supra* note 16, at 606.

25. Priest, *supra* note 10, at 531.

26. Gron & Winton, *supra* note 16.

three reasons. First, the high prices due to the high return for scarce capital allow insurers (and reinsurers) to increase their internal capital. Second, those same high returns provide incentives for insurers to access costly external capital and for new entrants to come into the market. Third, insurers will reduce their risk exposure by curtailing new coverage and renewals as noted. The duration of the tight market conditions depends upon how quickly all three of these occur.

This theory of insurer behavior has some considerable empirical support. As the theory would predict, measures of insurers' "capacity" (internal capital) bear a significant relationship to insurers' profitability.[27] Likewise, the theory predicts that the effects of "overhang" on current markets will last longer if previously issued policies have long-tailed coverage.[28] For example, many liability policies cover "occurrences" during the policy period, even if liability judgments associated with them may not be forthcoming for many years because of delays in litigation or latent injuries. Under property insurance, by contrast, coverage is generally for "events" during the policy period, and there is little risk of a covered loss coming to light after the policy period is over. Accordingly, risk overhang will likely persist longer in liability insurance markets than in property insurance markets if the theory is correct. Recent evidence supports the theory, as the 1980s' liability insurance crisis lasted considerably longer than the early 1990s' catastrophe reinsurance crisis.[29]

Before leaving this preliminary economic discussion, we wish to touch on one other point relating to large losses. As noted in the introduction, some types of losses, such as acts of war, are generally excluded from coverage under property-casualty policies.[30] The preceding discussion adds to our understanding of why this should be so. Losses associated with war will tend to be highly correlated across policyholders. Consequently, they can seriously threaten insurers' internal capital. A healthy insurer will thus be unwilling to sell insurance for such risks without tacking on a substantial risk premium to the price. The more the price of insurance exceeds its expected value, other things being equal, the less the demand among potential insureds. This problem is compounded by the fact that large correlated losses may impair insurers' capital to the point that they will be unable to pay claims, a prospect that further reduces the demand for insurance.

Thus, certain types of losses will only be insurable by the largest insurers with the greatest capital reserves and the highest degree of global diversification. As the number of potential insurers diminishes, market power issues may become a concern. Some potential losses are so catastrophic and non-diversifiable that no insurer will insure them for a price that customers will pay.

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27. *See* Gron, *supra* note 19.

28. Gron & Winton, *supra* note 16, at 592 (explaining that "tail" means length of time that it takes for a claim to be entered against an old insurance policy).

29. *See id.* at 601, 602 (reporting that the duration was roughly three years for the liability crisis as compared with one and a half years for the catastrophe reinsurance crisis).

30. Priest, *supra* note 10, at 1540-43 (discussing why losses from nuclear war are uninsurable).

B. Implications for Terrorism Insurance

The events of September 11 and their aftermath changed the information available to insurers in three ways. First, they suggested that the probability of very large terrorism losses was significantly greater than previously thought, or, in other words, the expected value of future losses rose considerably. Second, and related, they greatly heightened the possibility that losses caused by terrorists might be so large as to be uninsurable. Present concerns about the use of weapons of mass destruction by terrorists suggest that terrorism losses might conceivably be as great as those that might be experienced in wartime. Third, they greatly increased the uncertainty in insurers' subjective probability distributions regarding terrorism losses. The insurance industry must now adjust to these new conditions.

The increase in both the mean and the variance of insurers' subjective distribution of terrorism losses creates a short-term "crisis" in the availability of terrorism coverage through the risk overhang phenomenon described above. Insurers in the short term have increased the estimates of their exposure to terrorism risk. Many insurers have found that they have more exposure relative to their capital than they would like and are seeking to shed such coverage until they can manage the risk better. For some insurers this may entail covering some terrorism losses but managing them differently by selecting a different mix of exposures, as by insisting on a broader geographic area for the same number of risks.

As with past insurance crises, the problem is likely to go away with time. Barring massive new terrorist attacks, insurers' capital will increase, the perceived uncertainty about the distribution of losses will diminish, and insurers' risk premia for covering terror-related losses will fall. Upward repricing of future coverage for terror-related losses will then afford insurers a substantial degree of confidence that the coverage will be profitable.

We may also expect insurers to take steps in the months ahead to protect themselves against excessive exposure in the event of the most catastrophic terrorist attacks. Exclusions will be rewritten for a number of particular occurrences. "Act of war" exclusions, for example, may be rewritten to incorporate more clearly the use of weapons of mass destruction by individuals as well as by enemy states. The exclusion of any losses caused by such weapons, especially nuclear weapons, may become more common, as may nuclear hazard exclusions. "Bomb damage" is another category of loss that may become subject to greater exclusions and limitations. Such coverage might be excluded from basic casualty policies and available only through separate riders such as those for earthquake and flood damage in many jurisdictions. Coverage through separate riders allows insurers to take on risks selectively to ensure adequate diversification and also allows coverage to be priced more proportionately to each insured's exposure to risk. Insurers will also protect themselves through dollar limits of liability as they always have in the past.

These adjustments are well underway. Indeed, insurers are again willing to sell large amounts of coverage to airlines for ground damage caused by aircraft

and are thus urging the government to exit that market. Coverage for terror damage under property-casualty policies will likely return before long as well, subject to the sorts of changes noted above.

Insurance companies are not the only sources of "insurance" against terror-related losses. The catastrophe reinsurance crisis of the early 1990s spurred the growth of new financial instruments that allow risks to be allocated to the capital markets. Catastrophe futures and catastrophe bonds now allow any investor to contract to make or receive state contingent payments in the event of disasters. Payments, in the event of a catastrophic loss, are dependent on aggregate indices of insurance industry losses, thus eliminating any adverse selection or moral hazard that these contracts might otherwise produce.[31]

The adjustments that we describe for insurance markets are not yet complete, and we cannot know quite when the market will settle into a new equilibrium. One may therefore ask whether there is any role for government during the transition to a more stable situation. Further, the new equilibrium will likely entail some additional coverage exclusions, as well as limits on the dollar value of coverage, which make certain risks uninsurable that might previously have been covered. One can further ask whether government should step in to make coverage of these risks available. To these issues we now turn.

II. THE UNEASY (WEAK?) CASE FOR GOVERNMENT INVOLVEMENT

Consistent with our prior discussion, it is useful to divide the analysis between "transition" issues relating to the period of risk overhang and longer-term issues relating to risks that are uninsurable in the private market.

A. Transition Issues

The transition is ongoing to a market free of the current risk overhang, and its duration will depend on future experience with terrorism-related losses. Initially governments around the world stepped in to provide ground damage coverage for airlines on an ostensibly temporary basis. Since then, governments in the United States, Germany, and France have passed government-sponsored terrorism reinsurance programs.

With respect to airline coverage, at least part of the impetus for government participation is regulatory. Airlines are required to carry substantial coverage for ground damage (for which airlines are strictly liable under U.S. tort law), and policy cancellations after September 11 evidently placed airlines into a situation in which they could not comply with such regulations. As a result, airlines subject to these cancellations were unable to fly legally.[32] Some adjustment of government policy was in order at that point, and government provision of

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31. *See* Christopher Lewis & Kevin Murdock, *Alternative Means of Redistributing Catastrophic Risk in a National Risk Management System*, *in* THE FINANCING OF CATASTROPHE RISK, *supra* note 11, at 51.

32. *See Terror in the Air: Governments Are Still Under Pressure to Insure Airline Risk Terror*, THE ECONOMIST, Mar. 23, 2002.

insurance on a temporary basis may have been a reasonable choice among the available options (regulatory waivers or changes in liability rules being the others).

Even so, government involvement in the sale of airline coverage illustrates one of the important potential problems with government participation in the insurance market. At least some private insurers are once again willing to supply coverage but the airline industry objects that it is too expensive. As a result, government programs supplying temporary coverage have been extended beyond their original expiration dates. This policy obviously raises the concern that governments are supplying subsidized coverage, and that political pressures will induce continued coverage. In that event, government becomes the problem rather than the solution, crowding out private insurance with subsidized public insurance and allowing airlines to externalize the risks they create.

More generally, one must ask whether there is some market failure that government can constructively address. One familiar source of market failure is market power. It is conceivable that risk overhang creates a window of time in which market power may arise and be exploited. As noted above, some risks are so large and non-diversifiable as to be uninsurable, and others are large enough that only the most highly capitalized insurers will cover them. We would not expect market power to afflict the market for coverage of the latter types of risks in the long run because of competitive entry by large insurers or insurance groups. However, in a market afflicted by risk overhang, only the very largest insurer(s) with experience writing a particular kind of coverage might offer it for a time. During that window, premiums might include not only a significant risk premium but a monopoly markup as well.

The airline situation again offers a possible illustration. The largest insurance group in the world by capitalization, American International Group, Inc. ("AIG"), is precisely the group that has recently announced its willingness to supply ground damage coverage to airlines in amounts comparable to those available before September 11.[33] However, the airlines complained vociferously that this coverage is overpriced and have persuaded governments to remain in the market for now. We cannot rule out the possibility that AIG's premiums contain a monopoly markup. If so, government participation on a temporary basis might be justified in principle. But it is also impossible to rule out the earlier hypothesis that government coverage is a subsidy, and that the higher price of private coverage reflects sensible repricing in the face of increased risk.

The broader question of whether the government should go beyond assistance to airlines to supply other reinsurance coverage that the market will not supply turns on somewhat different issues. As noted, the capacity limitations that create risk overhang likely result from the relatively high cost of external capital to insurers, particularly after a series of events that produces large, unexpected losses. The high cost of external capital, in turn, is likely a product of asymmetric information between insurers and capital markets and a related

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33. *See A Nation Challenged: The Insurers; Sales Are Resumed for Coverage of Airlines for Terror Damage*, N.Y. TIMES, Sept. 25, 2001, at C4.

fear of adverse selection by insurers with large exposure under existing policies. A perceived shortage of coverage can also result from the high risk premiums that insurers will charge to write new coverage when the uncertainty about expected losses is great.

Can these circumstances be viewed as a "market failure" remediable by the government? The answer is somewhat complicated. There can be no question that conditions of asymmetric information reduce the efficiency of markets relative to a world of perfect, symmetric information. To call this a "market failure," however, is to indulge the nirvana fallacy. Governments are in no better position than the capital markets to judge the riskiness of placing capital at risk in insurance markets. Indeed, for reasons that we will elaborate in the next section, there is good reason to think that when the government acts as an insurer, its risk portfolio will be inferior to that of the private sector. Government reinsurance, therefore, would likely be more threatened with adverse selection than private reinsurance. We can think of no other policy instruments that government might constructively employ to ameliorate the problem of asymmetric information directly.

If an insurance market is suffering from unraveling due to adverse selection, however, government may improve matters by making insurance coverage mandatory. In theory, the same possibility seemingly exists for reinsurance markets. It is difficult to imagine how mandatory reinsurance would be constructed, and it is more difficult to imagine how government would determine when a dearth of reinsurance (or a period where its price seems high) could be addressed through any policy of mandatory reinsurance. Finally, when the adverse selection problem is only temporarily acute following a shock to the market, the danger arises that any government policies along these lines would be outmoded by the time they were implemented.

One might also argue for government participation because private reinsurers facing capacity constraints will charge substantial risk premiums to write coverage that may result in large losses. These risk premiums relate to the concavity of the profit function with respect to internal capital, which derives from the high cost of external capital (and perhaps bankruptcy costs), as previously noted. Arguably, government does not face these problems. In the event of a large, unanticipated call on the resources of the government as reinsurer, the government can still borrow in the capital markets at an attractive rate (at least the major Western governments). It need not pay the sort of premium that private insurers must pay to attract external capital, and it need not worry about costs of financial distress. Thus, the argument might run, in normal times when capacity constraints are not terribly important for private insurers, government should not act as an insurer because the private insurers' small risk premiums and their superior ability to manage and administer risk surely trumps any gains from shifting risk to the less risk averse government. However, after a large shock that creates risk overhang accompanied by large risk premiums to compensate private insurers for writing new coverage, the government has a substantial, albeit temporary, advantage in risk bearing, and should enter the market to exploit it.

The difficulty with this argument for government involvement is that

practical considerations may undermine any gains from temporary government participation as an insurer or reinsurer. The risk overhang problem abates with time, and may well diminish greatly before government can act to install a sensible program. Once the government program is in place, it may long outlive its usefulness. Government is unlikely to set premiums in actuarially sound fashion, and political pressures for subsidies will be intense. Once subsidized insurance is in place, a constituency to retain it indefinitely will emerge, and a considerable risk arises that poorly managed, but inexpensive, government insurance will crowd out efficiently structured private insurance.

In sum, we think it unlikely that government has much of a constructive role to play *as an insurer* in addressing the problems associated with temporary insurance "crises," whether in terrorism coverage or in some other line. In offering this conclusion, we stipulate that some sort of response was appropriate to avoid a regulatory shutdown of the airlines after September 11, and that government provision of ground damage insurance on a temporary basis appears to have been a tolerable response initially. The months to come should reveal whether the government can resist airline industry pressure for long-term subsidization of this coverage. We fear that if the government leaps into the business of providing terrorism insurance because of the risk overhang in the market, it could create long-term costs that would outweigh any short-term gains. A mix of inertia and political pressures make it unlikely that the government will respond properly, and in an appropriately transitory fashion, to these market disruptions that history suggests will resolve on their own.

B. Long Term Issues

It remains to consider whether government has some role to play in the long term. Thus, imagine a time in the not too distant future when insurers have accumulated enough experience with terror-related losses to be willing to supply coverage for the risks that they believe to be modest and diversifiable. Premiums will be higher than before September 11, and terror coverage for some insureds may have to be purchased separately. But coverage will be available in substantial dollar limits at premiums that are not terribly in excess of actuaries' best estimates of expected losses. At the same time, however, new exclusions in standard policies will likely make coverage for certain catastrophic terrorist acts unavailable altogether, such as acts involving the use of weapons of mass destruction. Here, the unavailability of coverage is not a transitory result of risk overhang, but a lasting manifestation of the fact that some losses are so large and undiversifiable that private insurers will not agree to cover them.

Should government offer to insure these types of losses? One might begin with a simple "no" based on the observation that there are numerous uninsurable losses, and government does not generally step in to cover them. Governments do not generally offer act of war coverage, for example, and it is not terribly difficult to understand why. In the event of a large scale war, a government promise to pay for losses might not be credible. Even in the event of smaller scale conflicts where the government's ability to pay might not be in issue, the optimal use of limited government resources may not be to reimburse property

owners for their losses. The needs of national defense and the provisions of emergency food, shelter and medical care, may well represent a higher priority.

This is not to suggest that government should do nothing in the event of a national catastrophe that presents a privately uninsurable risk. Quite the contrary, the government should and does assist those who have suffered losses. It simply does so on the basis of an ex post assessment of priorities rather than ex ante contracts with some subset of the population that has elected to purchase insurance. The federal assistance to New York and the compensation fund for victims of the September 11 attacks noted in the introduction are clear examples.

Ex post humanitarian assistance in lieu of ex ante insurance arrangements assuredly fails to achieve optimal risk allocation in any sense. However, government should have other considerations in its objective function besides optimal risk sharing, including distributional considerations that pure insurance markets will not address and the other sorts of expenditure priorities noted above. It would be exceedingly difficult to write an ex ante contract that accurately specified the act of war contingencies for which the government's promise to pay was credible and that the fulfillment of such a promise would not divert scarce resources from higher valued uses. This observation, we suggest, may well suffice to justify an "ex post" approach to government assistance in the event of attacks on the nation.

However, we are mindful of possible arguments to the contrary. One such argument is that properly priced government insurance arrangements might create valuable incentives. To the extent that certain types of activities or properties are at greater risk of harm from terrorist attacks, appropriately calibrated insurance premiums might discourage especially risky activities, discourage the construction of new properties that might represent easy targets, and encourage anti-terrorist precautions.

Such an argument must rest on the notion that ex post assistance provides a de facto "insurance," the price of which is not connected to each insureds' risk, which results in moral hazard. We do not doubt that ex post government assistance will create some degree of moral hazard at the margin. Indeed a number of writers have suggested that government disaster assistance creates moral hazard in other contexts, such as with crop failure and flood insurance.[34] These writers typically argue that market insurers are better able to police adverse selection and moral hazard problems than government and urge that government withdraw from disaster insurance and ex post disaster relief activities whenever the government presence discourages the purchase of private insurance that is otherwise available or "crowds out" private insurers.[35]

We concur, and we certainly do not entertain the possibility that government should *supplant* private insurers or reinsurers in the provision of terrorism coverage. The question here is a slightly harder one—should government shift

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34. *See* George Priest, *The Government, the Market, and the Problem of Catastrophe Loss*, 12 J. RISK & UNCERTAINTY 219 (1996); *see also* Scott Harrington, *Rethinking Disaster Policy*, 23 REGULATION 40 (2000).

35. *Id.*

from the provision of ex post assistance to ex ante insurance coverage with respect to the terror risks that are uninsurable in the private market over the long run? In particular, could such a shift be justified by the superior risk avoidance incentives that would result? The answer, we believe, is "no," for two reasons.

First, although ex post aid in the event of terror attacks creates some degree of moral hazard, the effect may be relatively modest because aid to terror victims is likely quite incomplete and uncertain. For example, the notion that the owners of the Sears Tower will eschew valuable precautions against terrorism on the grounds that they expect something approaching full compensation from the government in the event of its destruction seems uncompelling. It is also uncompelling that Sears Tower owners can avoid any market penalty for lax security because its tenants are secure in the knowledge that their decedents will receive compensation for their deaths. Here, the moral hazard problem is simply far less acute than it is when farmers who plant their crops near a river that regularly floods are routinely reimbursed for their losses.

Second, even if properly priced government insurance would create some valuable incentives, there is little reason to expect that government insurance would be properly priced. The critics of federal disaster policies have already shown convincingly that when the federal government becomes involved in the sale of insurance against disasters, it does little to classify risks or price policies in an actuarially sound fashion. To the contrary, policies are typically subsidized and lacking in experience-related pricing. Moreover, legislators cannot resist the urge to aid disaster victims who prove to be uninsured after the fact, so rational, potential insureds may decline to purchase insurance despite subsidized premiums.[36] In light of this experience, is there any reason to think that government terrorism coverage would be priced in a way that generated useful precautions against terror? Indeed, the Terrorism Risk Insurance Act of 2002 provides for federal reinsurance free of charge.

A second possible argument for government sale of ex ante insurance in lieu of government ex post aid is that even if premiums would bear little relation to those that an insurance industry actuary would set, accumulated premiums could create a sizable fund that could be used to finance aid to victims. This argument, too, seems unconvincing. Special government funds are fungible with general revenues (remember the Social Security "lock box"?). There is little reason to think that any such fund to aid terror victims would be segregated for the purpose that it ostensibly serves. There is also little reason to think that a segregated fund is necessary in any event. If the government needs a special reserve fund to aid terror victims, why not one to finance wars or to cover expenditures during a severe recession? Further, if a fund is somehow needed, what is the advantage of accumulating reserves through insurance premiums rather than general taxation? We have already disposed of the notion that insurance premiums are likely to create valuable incentives, and we are not aware of any other potential advantage to them. The notion that it is more equitable for potential terror

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36. *See* Harrington, *supra* note 34, at 44; Moss, *supra* note 12, at 343-44; Priest, *supra* note 34.

victims to contribute disproportionately to the fund through insurance premiums offers a possible argument, but a weak one at best, especially given that such individuals and companies may well contribute disproportionately to tax revenues already.

Even if government should not enter into the provision of terrorism insurance, other policy changes might be constructive. It has long been recognized that the tax treatment of insurance reserves against catastrophic loss (income is taxed as it accumulates) forces premiums higher and reduces private coverage. Other writers have urged reconsideration of this policy.[37] Similarly, we do not rule out the possibility that government might somehow aid in promoting (or not impeding) alternative private instruments for laying off terrorism risks in the capital markets, such as catastrophe bonds and futures. But for the reasons given here, long-term government entry into the market for privately uninsurable terrorism risks seems ill-advised.

CONCLUSION

For the reasons developed above, the case for more widespread government participation in the market for terrorism insurance seems a weak one. Insurers and insureds are already adjusting to the post-September 11 environment. We fear that government involvement will prove at best unnecessary and at worst a source of serious long-term distortions of the market place.

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37. *See* Harrington, *supra* note 34, at 42.

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